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Via Federal Express

September 29, 1999

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

Re: Performance Data and Disclosure for Commodity Trading Advisors

Dear Ms. Webb:

This letter is in response to the Commission's request for comments on the above-referenced proposed rules ("Proposed Rules") published in the Federal Register (64 Fed. Reg. 41843, August 2, 1999).

John W. Henry & Company, Inc. ("JWH®") is a registered commodity trading advisor ("CTA") managing over $2 billion in equity for leading money center banks, brokerage firms, retirement plans, insurance companies, multinational corporations, private banks, and family offices in the Americas, Europe and Asia. JWH also has several affiliates registered as CTAs and/or commodity pool operators ("CPOs"). As we indicated in our letter dated September 14, 1998 containing comments on the Commission's Concept Release published in the Federal Register on June 18, 1998, the presentation of performance results is crucial to the ability of an investment manager to market itself and its products successfully and to the ability of clients to evaluate an investment and its contribution to their portfolios. The Proposed Rules are, accordingly, of major importance to JWH, its affiliates and their clients.

General Comments

JWH supports the adoption of the National Futures Association ("NFA") proposal relating to performance disclosure for partially funded accounts managed by CTAs, as described in Section II-A - "Documentation of Nominal Account Size" of the Proposed Rules. Adoption of the NFA proposal will resolve a difficult issue that has been problematic for the managed futures industry since 1987. JWH believes that the disclosure proposal will assist investors in comparing the returns from different investments by putting rates of return on the same basis. JWH commends the Commission, the NFA and their respective staffs for addressing this important performance disclosure issue.

We note that the Proposed Rules contain several new proposals for performance presentation that were not included in the Commission's 1998 Concept Release. As a general matter, JWH continues to believe that, in the absence of specific problems raised by current performance presentation requirements, the rules that became effective in 1995 continue to be comprehensive and effective standards for performance presentations, and that periodic revision of these requirements is both expensive for CTAs and potentially confusing to prospective investors.

In the introductory paragraphs of "Section II - The Proposed Rules," reference is made to previous advisories on this subject and they are cited in footnote 2 to the proposal. The statement is made that the current rule proposals would codify definitions and other information contained in the cited advisories. It is not clear, however, whether the advisories would continue to be in effect if the proposed rules are adopted or whether they would be superseded entirely by adoption of the proposed rules. We believe that this point should be clarified.

One concept troubling to CTAs appears in "Section II-I - Commodity Pool Disclosure" of the narrative portion of the release. The language in this section of the Proposed Rules suggests that it is appropriate as a business and legal matter for CPOs to expand on their own initiative the performance capsules for CTAs who are managing assets in their pools. Specifically, the Release states: "In such cases, the CPO would be required to include in the performance capsule for each such CTA, in a column adjacent to the presentation of data based on nominal account size, the drawdown information required by Rule 4.25(a)(1)(ii)(E) and (F), computed on the basis of the ratio of the nominal account size to the pool's actual funds allocated to the CTA's program." Since this is strictly a pool-related disclosure, it should appear in the section of the pool disclosure document related to the pool's performance and not in the CTA performance capsule section. CTA performance should not be expanded or altered by a CPO. We believe that it would create a dangerous precedent if CPOs were permitted or directed to add to or alter CTAs' track records, particularly since CTAs are typically required by their advisory agreements to represent to the accuracy of such information and to provide indemnification if such disclosure is ultimately determined to be materially misleading. Moreover, the disclosure that is described here appears to be in the nature of a pro forma presentation of CTA performance results based on pool funding considerations. It is unclear whether additional disclosure is being proposed with respect to all of a CTA's performance record or only for a pool's actual performance record.

The same section of the narrative portion of the release states that the Commission is deferring consideration of changes to the requirements for disclosure of past performance by CPOs. While the further statement is made that the current proposal is intended to address the need to conform CTA performance presentations and pool disclosure documents, we are concerned, notwithstanding this statement, that additional proposals may be adopted or proposed in the near future that would again seek to alter CTA performance presentations.

Section 4.10(l)(3)

JWH supports continuation of the inclusion of interest accrued on funds deposited in a client's account at a futures commission merchant in the determination of net performance, as would be required by proposed Rule 4.10(l)(3)(C). It should also be clarified that interest earned on committed funds should be included in net performance. This is consistent with the apparent intention underlying Section 4.10(n)(2)(iii), requiring a CTA to have access to information concerning the designated balance in the accounts it manages. In proposed Section 4.10(l)(3), subsection (D) also should be clarified. It is not clear what is meant by the reference to "other income accrued on positions held as part of the CTA's program." If accruals on committed funds are meant to be included in this subsection, which may be the case, that should be specifically clarified.

Interest earned on a client's trading account has traditionally been included in a CTA's net performance for purposes of performance presentations. This practice, in fact, has been required by Commission rules since 1981, when CTA performance disclosure rules were revised. The Commission adopted the performance format that now is required by Rule 4.35(a)(6) because it determined that the previous format "... is not ... completely fulfilling its purposes. Therefore, a less complex approach to the presentation of past performance, which may sacrifice comparability but which is more readily understood appears warranted." [1980-1982 Transfer Binder] Comm. Fut. L. Rep. (CCH), ¶ 21,057 at 24,245.

The rules adopted on May 8, 1981 included in Rule 4.31(a)(3)(ii) a formula for calculating and presenting CTA performance, and defined "net performance" as "the change in the net asset value net of additions, withdrawals and redemptions." (The same definition applied to CPOs in Rule 4.21, and was incorporated by reference in the CTA rules.) When the CTA rules were revised in 1995, the same definition of "net performance" was retained in Rule 4.35(a)(6)(D), with the expansion of the exclusion to "fees and expenses." Thus, Commission regulation and industry practice have provided for inclusion of interest in net performance for almost 20 years. Departure from this well-established regulatory requirement and business practice would create a discontinuity in historical performance presentations and result in either (i) a divided performance presentation based on the use of different methods of calculation for different time periods, which would require expanded disclosure concerning the changes in the method for calculating rates of return, or (ii) massive time commitments for the purpose of revising and restating CTAs' performance records. In the case of revision and restatement, there would still be differences between the restated results and those previously published by the CTA, and often by CPOs and industry observers as well. In our opinion, the credibility of historical CTA performance records and that of the managed futures industry would be undermined substantially by either of these alternatives.

In addition, JWH believes that there are several other strong arguments for continuing to include interest earned or accrued on a managed futures account in a CTA's performance history. Economically equivalent investments should produce economically equivalent returns and regulatory requirements should not distort the economics of an investment or its rate of return. This is particularly of concern given the nature of futures contracts.

A futures contract obligates an investor to buy or sell a financial instrument or index or a physical commodity at some date in the future at an agreed price. Futures connect today's cash markets with tomorrow's cash markets. Pricing of futures contracts can be expressed by the general equation:

Futures price = Spot price + Cost to Carry.

Cost to carry reflects the costs that an investor would incur to buy and hold the commodity underlying the futures contract to the scheduled settlement date. While these costs vary depending on the underlying commodity, financing costs are an integral component of the cost to carry all future contracts. In essence, futures allow investors to gain exposure to markets without having to advance the cash market value. Instead, the cost of financing the investment is built into price of the future.

For example, an investor with $1 million of cash who wants to invest in the S&P 500 has three choices:

1. Buy the stocks comprising the S&P 500 in exact proportions of the index;

2. Buy shares in a S&P 500 index fund; and

3. Buy S&P 500 index futures.

Under Options 1 and 2 the investor would use the $1 million of cash to buy stocks or mutual fund share purchases and to pay related transaction costs. Under option 3, the investor would buy S&P futures and leave the $1 million invested in cash, including amounts posted as margin with a FCM. Thus, under Option 3 the investor will have two investments: futures and cash balances. Ignoring transaction costs, the investor should expect to earn similar returns in each of the three options.

The recent price for the December S&P 500 future illustrates this. On September 30, the S&P 500 was 1286.79 and the December 99 futures contract was 1299.50. The 12.71 difference between the spot and future price is equal to 78 days of interest at an annual rate of 6.08%, less estimated dividends at a yield of 1.55%. If the S&P 500 remains unchanged over the 78 days, the investor's total return under option 1 and 2 would be 0.0% plus estimated dividends of $3,312. Under option 3, the investor would settle the future contract in December at a $9,781 loss ($1 million / 1299.50 * 1286.79) and earn $12,993 on cash balances assuming a 6.08% interest rate ($1 million * 6.08% * 78 days / 365 days) for a net gain of $3,212.

Unless the interest earned on cash balances is considered, returns earned on futures will always appear to under perform direct investments in the commodity or financial instrument underlying the future.

Finally, we believe that the exclusion of interest from the net performance of CTAs would represent a step away from the long-standing Commission objective of increasing comparability of rates of returns across different categories of investments, an objective that received considerable discussion during the Part 4 rule revisions in 1994-1995. For example, if a prospective investor is considering the alternatives of an investment of a managed futures account and a commodity pool, interest income should be presented as part of the rate of return on both investments. Assuming that fees and expenses are otherwise the same for a pool and a managed account, both managed pursuant to the same program by the same CTA, the exclusion of interest from the CTA's performance record will create an artificial comparative advantage for the pool, when the returns on the two investments should be the same. Continuing to require inclusion of interest in CTA net performance will maintain comparability of returns calculated under the Commission's requirements and those calculated under the performance standards established by the Association for Investment Management and Research.

Section 4.10(m)

In Section 4.10(m), the word "account's" should be added after the word "client's" and before the word "level" for the sake of consistency.

Section 4.10(n)

In Section 4.10(n), reference is made to committed funds and to "written evidence" of committed funds. Committed funds are not defined in the proposed regulations. Do the definitions contained in Advisory 87-2 still control this issue? It also is not clear which parties should sign written evidence of fund commitments. For example, must a client's futures commission merchant still sign a committed funds letter as required by Advisory 87-2? With respect to Section 4.10(n)(2), JWH believes that reference to funds not being otherwise encumbered, as required by Advisory 87-2, is an important point which should be added to the list of requirements for committed funds in this rule.

Section 4.25(a)(1)(ii)(H)

See comment above related to the narrative in Section II-I - "Commodity Pool Disclosure" of the release.

Section 4.33

This proposed rule should be clarified or otherwise modified to state that it applies only to those CTAs that accept notional funds.

Section 4.35(a)(1)(iv)(A) and (B)

In this proposed rule, reference is made to committed funds. The specific scope and intent of this term should be clarified. In addition, the proposed requirement that CTAs disclose the aggregate of actual funds committed to its trading programs conflicts with the disclosure approach to partially-funded accounts that is incorporated in the NFA proposal. JWH supports the NFA approach: the amount a CTA is directed to manage is the crucial disclosure point, both for presentation of rates of return and as the amount upon which a CTA makes its trading decisions.

Section 4.35(a)(l)(v) and (vi)

The proposed requirements for disclosures about drawdowns for nominally funded accounts are not clear. JWH questions the need for introducing an additional set of disclosure items that would be provided to all potential clients, even if notionally-funded accounts are not regularly or frequently solicited or accepted by a CTA. The presentation of drawdowns related to notionally-funded accounts for each of a CTA's programs to all of a CTA's clients and potential clients overemphasizes the importance of notional funding to many CTAs, including JWH, which traditionally has not accepted notionally-funded accounts. Moreover, specific additional disclosure requirements related to drawdowns for partially-funded accounts seem to us to be a reintroduction of the importance of differences in client funding decisions which adoption of the NFA proposal should end. Notionally-funded accounts' drawdowns could be misunderstood by potential investors, and in any case would require additional narrative disclosures to explain the presentations. JWH believes that a more appropriate approach to this disclosure issue, if additional disclosure about drawdowns for partially-funded accounts is deemed necessary, is to require CTAs to present such specialized disclosures only when they are soliciting or accepting notionally-funded accounts. For example, a special supplement presenting this drawdown information to clients who may establish partially-funded accounts would be the most efficient method of disclosure, and would focus the disclosure on those clients who have a specific need for it. An additional complication arises from this proposed rule in the context of CTA performance presentations in pool disclosure documents: since pools generally present the same CTA performance records that are shown in the CTA's disclosure document, but pools seldom partially fund accounts, the resulting disclosures in a pool document would be irrelevant to pool investors.

Section 4.35(a)(l)(viii)

In subsection (viii), (A) and (B), the requirement that ranges of rates of return be disclosed for closed accounts is problematic for CTAs. This proposed disclosure would be an entirely new disclosure for all accounts, unrelated to client funding decisions. Ranges of performance are meaningless and can be misleading to an investor without disclosure of the relevant time frames or of the timing of the investment. For example, a range might include an account that has a 200% return over 10 years and another that has a 1% return over one month. Such a range of performance data would be at least confusing and potentially misleading to investors. Secondly, the disclosure of "lifetime performance" will impose a significant new burden on many CTAs. Imposing this additional disclosure without additional guidance to an investor could foster the creation of incorrect assumptions about the relevance of this information that will cloud an investor's decision-making. Trading advisors with many accounts are likely to have a significant number of older accounts and it is possible that records prior to the mandatory five year reporting period may not be available, would be available only at great expense, or would require consumption of significant amounts of staff time in retrieving, comparing and analyzing such returns. JWH believes that imposition of such a requirement could in fact create a significant additional burden for CTAs, contrary to the Commission's expectation. In addition, this proposed disclosure places undue importance on the results achieved for individual accounts, which may have no bearing on the results of other accounts.

Moreover, the focus on the results of an individual account may trigger the need for additional narrative disclosure related to the circumstances of those accounts' performance. We are not aware of any comparable performance disclosures provided by, or required of, other investment managers, so these proposed disclosures would do nothing to increase the comparability of returns across investment sectors. The likely result is the proliferation of disclosures that are of questionable value to clients, and a shift of emphasis from the importance traditionally placed by the Commission rules on composite presentation of performance. Finally, this proposed disclosure suggests that the performance of closed accounts should be highlighted through disclosure in a way that the performance of open accounts does not. In fact, decisions by clients to close accounts can and do have many explanations, not all of which are related to performance.

Section 4.35(a)(l)(ix)

Although we oppose the addition of more drawdown information, if this portion of the proposal is adopted, either in full or in part, the formula for the proposed expanded drawdown disclosures calculation in subsection (ix)(B) should be stated more clearly. The status of accounts that have qualified for inclusion in a performance record under the fully-funded subset method must also be addressed. We advocate that if an account is not fully-funded but has qualified under the fully-funded subset approach of Advisory 93-13, it should be treated under the proposed rule as fully-funded, as it has been in the past. This issue should be addressed directly and an example given of any required calculation.

Subsection (ix)(B) should also be modified to add the word "aggregate" between the words "on" and "nominal." Later in this proposed rule it is stated that advisors without sufficient information regarding funding levels should assume a funding level of 20%. No justification is given for this assumption. That should be clarified in any final rules that are issued. In subsection (ix)(C), any required statements about "the percentage of client accounts in the program for which actual funds committed equal the nominal account size" is of limited value without specification of the time period(s) involved.

Section 4.35(a)(2)

Subsection (ii) requires additional disclosure of performance in bar graph format. This proposal also is a new disclosure requirement unrelated to issues of partially funding of an account. JWH believes that the tabular format for presentation of rate of return information is most useful to clients, since it is our experience that most clients prefer actual performance data to use in their own analysis. The tabular format also ensures that any comparisons of rates of return are fully understood by clients. Bar graphs have the potential to mislead investors by focusing attention on visual indicators of performance levels which will be imprecise compared to actual data, and also are potentially misleading when used for comparative purposes, particularly when the graphs being compared use different axes. Graphs are likely to vary between programs and between CTAs. As a result, the risk of confusion may be particularly great for retail-type investors.

Section 4.35(a)(6)(i)(E)

The last sentence of subsection (i)(E) concerning the timing of changes to nominal account size is ambiguous and should be clarified.

Section 4.35(a)(6)(ii)

After the reference to Section 4.35(a)(6)(i)(A-F), the phrase " – and not the supporting documentation itself – " should be added. This will conform the language of the rule to the narrative portion of the release (Section (II-D).

If the Commission and its staff believe that further discussion of any of the issues raised in this comment letter would be useful, we would be happy to participate in further development of performance disclosure rules that serve the goals of more meaningful performance presentations.

Sincerely yours,

David M. Kozak

DMK/eas
cc: Daniel Roth, National Futures Association

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