RECEIVED
C.F.T.C.

03-04
2

Paul H. Bjarnason, Jr.
4712 Montgomery Street
Annandale, VA 22003, USA
703-941-0926
"bearson@crosslink.net"

2003 MAR 28 AM 10: 06

OFC. OF THE SECRETARIAT

March 27, 2003

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

COMMENT

Received CFTC Records Section
03/28/2003

Submitted via e-mail

RE: "Performance Data and Disclosure for Commodity Trading Advisors"

Dear Ms. Webb:

I hereby submit my comments in response to the Commission's request for comment on the above-referenced rule proposal. I am a certified public accountant and hold an MBA (concentration in finance). As of March 31, 2002, I completed a career involving accounting, financial reporting and regulatory matters. The first 7 years of my career was with an international auditing firm. The balance of my career comprised 29 years in the Federal Government, including approximately 3 years at the Securities and Exchange Commission (Division of Corporation Finance), 7 years at the Department of Energy (Financial Reporting System Project) and, lastly, about 19 years at the Commodity Futures Trading Commission ("CFTC" or "Commission"), where for many years my areas of responsibility, as Deputy Director for the Audit and Review Unit and Chief Accountant for the Division of Trading and Markets, included direction of the Commission's managed funds regulatory program. In this capacity, I worked directly on the issues contained in the above-referenced notice of proposed rule-making.

Summary

Following is a summary of the issues raised by this proposal and the recommendations I have for the Commission in this connection:

1. It is difficult to assess the probable impact of the proposed rules, because of the several methodologies for computing performance data now in use in the industry. The methods now in use appear to include the proposed nominal account size method. In making my assessment of each aspect of the proposal, I used the "traditional" actual funds method.

2. That the proposed nominal account size method (originally proposed by the National Futures Association ("NFA")) has, apparently, already been adopted by some CTAs raises compliance issues on two fronts. First, any CTA using a method not permitted by the Commission's rules would be in apparent violation of those rules. Also, inasmuch as NFA is the "front line" auditor for the managed futures industry, this raises a question as to the effectiveness of the design or execution of NFA's in-field audit program.

3. The nominal account size method should not be adopted. It is not a "method" in the scientific sense of the word. It will not achieve the claimed "comparability" across CTA programs. Its use as a divisor in the computation of performance figures will skew reported performance figures in ways harmful to the cause of customer protection, by resulting in lower key indicators of program risk, as compared to the actual funds method. The ways are set forth below in the following issues areas 2 - 4.

4. The nominal account size is, most always, much larger than the actual funds contained in a customer's account. Therefore, its use, in lieu of the actual funds amount, would provide much lower reported negative rates of return as compared to the actual funds method.

5. Composite data is an average of all accounts participating in a CTA program. As such, program data, based upon composite figures, does not represent and will not reveal the more extreme losses suffered by individual accounts. Therefore, the computation of risk indicators, such as the worst monthly drawdown and peak-to-valley declines,

should be based upon worst case individual accounts in order to make the risk of a CTA's program as clear as possible to prospective customers.

6. Reported negative lifetime returns for accounts closed within the last 5 years will be dramatically reduced under the nominal account size method, compared to the actual funds method. This is because the amount of funds put up by most customers is usually only a modest fraction of the nominal account size.

7. If the Commission adopts the nominal account size method, allocations of interest income earned in a master account to the related CTA trading programs should not be permitted, on the basis that it has determined that the amount of actual funds is irrelevant to a CTA's trading program.

8. Accounts opened prior to the 5-year disclosure time frame, which are closed during the 5-year time frame, should not be excluded from the computation of the range of lifetime losses for closed accounts. The exclusion of such accounts may lower the reported negative lifetime returns because fewer accounts would be included in the computation.

9. Core principles, by their broad and general nature, would allow CTAs latitude to omit key indicators of program risk and to compute their performance ratios in non-standard and, hence, non-comparable ways. Because of this, enforcement cases regarding performance figures would be very difficult to bring, except in the most egregious cases, such as where numbers are simply made up.

10. The actual funds method should be retained and improved as the basic method of performance reporting. For the reasons cited above, the Commission should not permit the use of the nominal account size, in any respect, to enter into the computation of performance returns. Advisory 93-13 should be repealed.

11. Given the apparent difficulty the Commission has had in evolving the framework of CTA performance reporting rules, the Commission should consider delegation of this function to an independent rule-making body, such as the American Institute of Management Research ("AIMR"). It is important that any entity receiving such

delegation be demonstrably and appropriately dedicated to the public interest.

Discussion of Issues and Recommendations

1 - Issues Regarding the Expected Impact of the Proposed Rules

This section explains the assumptions I have made in assessing the impact of the proposed rules. First, let me say that it is difficult to make such an assessment because the impact of each of the proposed changes is determined by the calculation methodology currently used by each CTA. To obtain information on the methods currently in use, I consulted several individuals who are well-acquainted with the current state of the managed funds industry. I was advised that the three methods for computing performance returns currently in use are:

1 - the "traditional" actual funds method, wherein the divisor for performance return calculations is the amount of funds on deposit in a customer's commodity interest trading account;

2 - the fully-funded subset method, pursuant to Advisory 93-13, which has as its primary requirement the subset. The divisor is the nominal account size; and

3 - the proposed nominal account size method, which also utilizes the nominal account size as the divisor, but which requires no fully-funded subset.

For CTAs already using the proposed nominal account size method, there would be no change in the figures reported. For CTAs using the first two methods the proposal, if adopted, would in many cases result in significant changes in the performance figures they report. In particular, performance figures for CTAs using the Advisory 93-13 nominal account size method could change, since the proposed rule contains no requirement that they calculate a return using a fully-funded subset method. Since nominal account sizes could be set without reference to a fully-funded subset, there is no reason why the account sizes used in the calculation would not increase in size and, thus, change the percentage returns. For CTAs using the "traditional" actual funds method, performance figures would change quite a bit. This is because nominal account sizes are inevitably much larger than the amount of actual funds a client puts up as margin. (These factors are discussed at length later in this comment letter.)

Therefore, because of the variety of performance computation methodologies in use by the industry today, I have described expected impacts in terms of the "traditional" actual funds method. This approach is consistent with my own proposal in this comment letter that Advisory 93-13 be radically revised or repealed. I have described the impact of adopting the proposed rules against what I believe is the ideal methodology.

2 - Compliance Issues

There is an important compliance issue regarding the third method. I was somewhat surprised to be told that the proposed nominal account size method is already in wide use. If true, this means that some CTAs have actually "jumped the gun" and are in apparent violation of the Commission's performance reporting rules. And, it appears that NFA's audit program has been ineffectual in preventing this.

NFA is the "front line" regulator of the managed futures industry. As a self-regulatory organization ("SRO") subject to the Commodity Exchange Act, NFA is required to have an effective program for monitoring compliance with the regulations under the Act. The Commission and the public rely on NFA to ensure that CTAs under their jurisdiction provide the public with complete, high-quality information regarding their past performance so that prospective clients can make an informed decision about entrusting their funds to a particular CTA. I recommend that the Commission look carefully at how well NFA's surveillance over CTAs is designed and executed.

3 - The Nominal Account Size Method is not a "Method" and the Resultant Performance Results Are Not Comparable Across CTAs

The release states that: "The Commission does not intend to impose a standard for the setting of nominal account sizes on CTAs.", and that: ". . . the Commission has observed that there is no standard among CTAs for the setting of nominal account sizes." The Commission cites the benefits of adopting the nominal account size method as: " . . . adopting nominal account size as the denominator for the rate of return calculation would provide a *uniform basis* for all CTAs to present rate of return . . . Use of nominal account size would permit a *much more meaningful comparison* of the performance results of CTAs."

This last statement is false. Since there are (and will be) no standards for establishment of the nominal account size, the nominal account size and any figures which result from computations based upon it, have no meaningful significance from an analytical standpoint, including comparability amongst CTAs. Moreover, the figure known as the "nominal account size" will be merely "data" (i.e., just a number) but will not constitute useful "information" (*i.e.*, not a number which means anything).

To justify the nominal account size method, the Commission's release, among other things, indicates that it thinks futures are different from other forms of financial activity. This, also, is not true. For all financial activity, it is the amount of "actual funds" that is the basis for financial decisions and the measurement of economic performance -- whether it be futures, securities, real estate or any other investment venue. Also, leverage can be had in all of the other financial venues. I believe it would be a mistake to depart from the underlying standard of measurement used by the rest of the financial world -- actual funds. If comparability is an essential objective to be achieved by the Commission (and it should be), the nominal account size method, as proposed, is not acceptable. Improvements can be made to the actual funds method, as discussed later herein.

4 - <u>The Nominal Account Size Method Would Result in Lower Drawdown Percentage Amounts Compared to the Actual Funds Method</u>

The proposal will reduce drawdown percentages reported by CTAs. That is, adoption of the nominal account size method will dramatically lower the public's perception of the amount of risk entailed in participating in CTA programs, as compared to the actual funds method. The drawdown percentages (*i.e.*, large historical losses incurred), which CTAs are required to disclose, are key risk indicators designed to warn customers about the volatility of a CTA's program. The requirement for the disclosure of these percentages was put in place to provide prospective CTA customers with tangible evidence that a lot of money can be lost in a CTA's program. The proposed rule change will lower these reported percentages.

To be most effective as a risk warning, these figures should be as high as possible. The Commission indicated in its release that it believes that the impact of this rule change is neutral, *i.e.*, that the use of the larger nominal account size-based divisor would not sway customers one way or the other, because positive and negative returns would be equally changed. I disagree with this view. I believe that a customer seeking to understand risk probably would (and should) focus more on the negative figures than on the upside profit figures. I believe that the discouragement value of large historical negative percentages would be more powerful than the encouragement value provided by commensurately high positive returns. Thus, I believe that any reduction in the size of the negative amounts will not be equally offset by similar decreases in the size of positive returns.

The nominal account size method will dramatically *depress* the percentages reported, compared to the actual funds method, in two ways. First, the reported percentages will be reduced because the divisor in the computation will be increased across the board by this proposed rule change. The Commission's release states that it is rare for CTAs to have fully-funded accounts. This is consistent with my understanding that CTA-set nominal account sizes are most always much *larger* than the amounts of actual funds placed in trading accounts by the customers of CTAs. Given this relationship, if the Commission changes the methodology used to one which has a much larger divisor, the resultant percentages will dramatically drop in size across the board.

Secondly, the reported figures will also be reduced because of different ways the account sizes of the customers (i.e., the divisor) will fluctuate (or not) over time. It is my understanding that most CTAs have agreements which fix the nominal account size at the same amount, regardless of profits or losses which ensue from month to month. In contrast, the amount of actual funds fluctuates, as profits or losses are incurred. This difference causes a big difference in the resultant monthly performance figures.

To illustrate this, I will use a simple example: let us assume a \$100,000 nominal account size and a \$50,000 actual funds account size. Assume \$10,000 per month is lost in each of three consecutive months.

Further, assume no deposits or withdrawals of funds to or from the customer's account during these time periods. Under the nominal account size method, the reported percentage losses are: month no. 1 – negative 10%; month no. 2 – negative 10%, and month no. 3 – negative 10%. Under the actual funds method the reported percentage losses are: month no. 1 – negative 20%; month no. 2 – negative 25%; and month no. 3 - negative 33%. As can be seen, the negative returns are substantially larger under the actual funds method.

Thus, it should be clear that the actual funds method reveals negative returns and, hence, risk and reward in a much more accurate and dramatic fashion than does the nominal account size method.

5 - Use of Composite-Based Worst Monthly Drawdown and Peak-To-Valley Amounts Will Reduce Percentages Reported, Compared to Individual Account-Based Data

The Commission proposes that the disclosure of the maximum monthly drawdown and peak-to-valley negative returns be based upon historical monthly *composite* amounts in lieu of the worst performing *individual* account in the program. No reason for this change was stated in the release.

I believe that, if prospective customers are trying to understand risk, as they should be doing, they should be far more interested in the worst case of all accounts – not the average of all accounts. It is a well known fact that the performance of accounts in the same program may differ widely on occasion. This is especially true during volatile or fast markets where order fills can differ greatly, even though the orders are put in at the same time. This means that individual account data is much better than composite data for displaying program risk. To draw an apt analogy, if a patient is doing a pre-operative interview of his prospective surgeon, the patient should be interested in the possible worst case scenarios and whether his prospective surgeon's past patients had experienced those negative outcomes – not what happened in the majority of surgeries. By the same token, composite data is not an effective way to illustrate down-side risk. Therefore, the worst individual account should be retained as the basis for the disclosure of worst monthly drawdown and peak-to-valley negative returns.

6 - Reported Lifetime Rates of Return on the Basis of the Nominal Account Size Method Will Dramatically Reduce Reported Negative Returns

The Commission proposes to have CTAs use the nominal account size as the divisor to compute the lifetime negative returns for accounts closed during the past 5 years, in lieu of the amount of actual funds posted by customers.

Under the actual funds method, the computation and disclosure of lifetime of the account returns is based upon the amount of actual funds attributable to the CTA's program. Under the proposed rule, that same customer's negative return would be computed using the nominal account size. As noted earlier, the nominal account size of a customer is, most always, much larger than the amount of actual funds posted by the customer. This would lessen the computed negative return dramatically. Let us take an example similar to the example mentioned above, with the $100,000 nominal account size, $50,000 actual funds size, but assume that the lifetime losses in the account net to $50,000. That is, the customer lost all of the $50,000 in cash funds he put into the program. Common sense would dictate that the lifetime loss was 100 percent. And, any prospective customers, seeking to know how other past customers had done, would expect to be told the losses were 100 percent. However, under the nominal account size method the customer's loss was only 50 percent. The Commission should not make this rule change.

7 - Allocation of Interest Income and Determination of the Amount of Actual Funds under Management

The proposed rules appear to permit the allocation of interest earned in a master account to the trading programs of the related CTAs. Further, it is my understanding that many commodity pool operators allocate interest earned in their master accounts to the CTAs who trade for their commodity pools, so that the CTAs can include the interest earned in the calculation of net performance.

In apparent contradiction to the making of these interest allocations, it is the industry's position and the Commission appears to agree, that liquid asset allocation schemes do not work. This view, apparently, only applies to the allocation of principle. The industry and the Commission appear to believe that the interest income can be logically allocated. These positions are inconsistent with each other, because the concepts and the mechanics of the two calculations are, essentially, the same.

Personally, I believe that *both* the allocations of principle and the related interest income can be done, provided the parties involved share the necessary information. The necessary data includes: the amount of margin requirements; open trade equity; and margin funds on deposit. I recommend that the Commission insist on the cooperation of all parties in providing data to CTAs, to perform the performance calculations on an actual funds basis. However, if the Commission adopts the nominal account size method, allocations of interest income earned in a master account to the related CTA trading programs should not be permitted, on the basis that it has determined that the amount of actual funds is irrelevant to a CTA's trading program.

8 - <u>Exclusion of Accounts Opened Prior to the 5-Year Reporting Time Frame, from the Computation of the Disclosure of the Lifetime Rates of Return</u>

The Commission proposes to reduce the number of accounts entering into the computation of the disclosure of lifetime positive and negative returns by excluding accounts which were opened prior to the beginning of the 5-year reporting period. Presently, the group of accounts entering into the computation is comprised of any account open during the 5-year reporting time frame (including accounts opened prior to the inception of the 5-year time frame) and closed before the end of such time period. The Commission proposes that, to be included in the computation of the range of positive and negative account lifetime returns, an account must have been *both* opened and closed during the 5-year period. This will reduce the number of accounts entering into the computation of the disclosure.

In its release, the Commission stated no reason why this change has been proposed. Based upon my own experience in proposing rule changes, valid reasons for a rule change could include the improvement of the customer protection value of the disclosure and the elimination of an undue burden upon the CTAs subject to the rule. Neither of these applies to this proposed change. If the goal is to display the worst-case scenario, any reduction in the number of accounts included in the calculation may result in the omission of the worst-case account and, thus, a lowering of the perceived risk of the CTA program. Since this proposed rule change may result in a reduction in useful information, it should not be adopted.

9 - Use of Core Principles in lieu of Rules for Performance Reporting

The Commission proposes that core principles replace detailed regulations governing the computation and presentation of CTA performance. The release states: "Such a core principle would permit CTAs to present past performance to prospective clients *in any manner they choose* so long as such information is offered in a manner that is factual and balanced and is not misleading or fraudulent." The Commission has requested other proposed language for core principles.

Core principles, by their broad and general nature, will allow CTAs latitude to omit key indicators of program risk and to compute their performance ratios in non-standard ways. Without detailed regulations on how the figures must be calculated and what must be disclosed, there will be no uniformity or comparability. Without clear and specific rules, the Commission would have no basis for successful enforcement action, except perhaps in the most extreme cases, such as where a CTA has totally fabricated its performance numbers. The adoption of a core principles approach would not be a good idea, under any circumstances.

10 – Retain and Improve the Actual Funds Method

As already mentioned above, retail customers (which I define as relatively unsophisticated private individuals) of CTAs assess their investing of all kinds based upon the amount of money required to support the investment activity. The amount of actual funds needed is the prism through which any and all investing activities are viewed by the average retail investor. To supplement the use of the amount of actual funds, sophisticated investors often use other means of assessment, such as mathematical models which utilize value-at-risk methodologies. Even so, the amount of actual funds remains the common denominator for all financial activities. Because of the actual funds orientation of the retail investor, there is, certainly, a basis for comparison across all CTAs of actual funds-based data. It is a proven and widely accepted and understood methodology. My suggestions for improving the present actual funds method are:

- For the same reasons discussed above as to why the proposed nominal account size method should not be adopted, the nominal account size approach contained in Advisory 93-13 should be discarded, *entirely*, for the computation of rates of return and other related percentage amount disclosures, such as the lifetime negative rates of return. Therefore, Advisory 93-13 should be repealed.

- As discussed above, liquid asset allocation schemes can be made to work. The Commission should require industry participants to cooperate with CTAs in doing liquid asset allocation scheme calculations. This would provide CTAs the data they need for their actual funds-based performance calculations.

- Rates of return should be computed and disclosed for each month on three bases: the average for the group of accounts; the highest individual return; and the lowest individual return for the month. The presentation of these three percentages for each month would effectively communicate the variability and volatility of returns, due to differences in funding amounts, trading results and other differences. To avoid a proliferation of performance tables, the Commission should permit the inclusion of accounts with differing rates of return in the same composite table, provided the absolute amounts of net performance returns for the nominal account size groupings are materially the same. For this determination, the gross trading profits ratio test, contained in Advisory 93-13, would be useful.

11 - <u>Delegation of Performance Reporting Rule Making to an Independent Body</u>

Given the difficulty the Commission has had in making progress in the managed funds performance reporting area, the Commission may wish to consider delegating the performance rule making function to a body similar to the Financial Accounting Standards Board (FASB). The FASB is an independent board with the objective of serving the public interest. It does not have the conflicting objective of representing any industry interests. It is relatively immune to political pressure from the industry, except perhaps through the Congress. FASB has a public rule making process, which involves public hearings on major issues, extensive expert testimony and receiving public comment on proposed rule makings.

In the investment performance arena, for many years, the American Institute of Management Research (AIMR) has served a FASB-like function and its rule making process is structured similar to that of the FASB. It is my understanding that most of the major investment advisors compute and present their past performance pursuant to AIMR standards. The AIMR has already developed performance reporting standards which contemplate the leverage of derivatives traded as part of a securities investment program. In addition to dictating how performance figures must be computed and presented, AIMR standards include data verification procedures, which must be carried out if an investment advisor is to represent to the public that it is following AIMR standards. Many CTAs are registered with the Securities and Exchange Commission as investment advisors. Therefore, the AIMR would be a good choice by the Commission to assist it in the development of CTA performance reporting rules.

Conclusion

This package of proposed rule changes is anti-customer protection. If adopted, these rule changes would result in a lowering of CTA risk profiles. Prospective customers may be lulled into a false sense of security about the risk of CTA programs. The nominal account size method will not achieve comparability of CTA program data. The core principles approach is even more anti-customer protection than the proposed rules. There would be no detailed standards with which to bring an enforcement action. The Commission should retain and improve the actual funds method, as the best basis for the calculation used to reveal CTA program risk. I recommend that the Commission seek the assistance of an organization, which is independent of the managed funds industry, to help it improve its performance reporting rules. Finally, the Commission should carefully scrutinize the design and execution of NFA's audit program over CTAs.

I appreciate having had the opportunity to share my views with the Commission.

Very truly yours,

Paul H. Bjarnason, Jr.