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COMMENT

April 14, 2003

Received CFTC
Records Section
4/15/03

Via E-Mail (Secretary@cftc.gov)

Ms. Jean A. Webb
Secretary
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;
68 *Fed. Reg.* 12001 (March 13, 2003)

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 Director of the Managed Funds Association (MFA), a member of MFA Government Relations Committee, Futures Industry Association (FIA), the Alternative Investment Management Association (AIMA) in London, 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 and has served on Special Committees of the National Futures Association (NFA). Mr. Bell is also on the Editorial Advisory Board of *Futures Industry* Magazine and on the Board of Editors for the *Futures & Derivatives Law Report.* The firm's experience and industry involvement are the basis for substantial interest in the proposed revisions.

We submitted a comment letter dated September 30, 1999 to the CFTC in response to request for comments published in 64 Fed. Reg. 41843 (August 2, 1999). The comments expressed in that letter remain relevant, particularly as that letter addresses the necessity for a change in performance reporting rules and the merits of adopting nominal account size based reporting. This comment letter will only address the subject matter of the CFTC March 13, 2003 release.

The role of notional funds in the calculation of CTAs' returns has been an ongoing issue as the number of partially funded accounts has increased over the years. CFTC Advisory 93-13 (*Computation and Presentation of Rate of Return Information and Other Disclosures Regarding Partially Funded Accounts Managed by Commodity Trading Advisors*) provided a compromise allowing the inclusion of partially funded accounts in the composite at nominal account size, but required the rate of return to be computed on the fully-funded accounts only. Advisory 93-13 did not solve the problem of CTAs without any fully-funded accounts. In 1998, the Commission sought public comment on the issue of notional funds in a Concept Release and, in August 1999, published proposed rules to allow the use of Nominal Account Size as the denominator in the rate of return calculation. The August 1999 proposal never resulted in final rules. On March 13, 2003, the Commission again published similar proposed rules addressing comments received on the August 1999 proposal (*Federal Register*, Vol. 68, No. 49). In the narrative, the Commission states that Advisories 87-2 (*Defining the Term "Beginning Net Asset Value" for Purposes of Computing Rate of Return*) and 93-13 and Interpretive Letter 88-1 (*Application of Division of Trading and Markets Advisory 87-2*) would be superseded in their entirety, on a prospective basis, if the proposed rules become final.

Notional funds pre-date the authorization of the CFTC in 1974 and since the first publication of Part 4 regulations in 1979, performance reporting by CTAs has been problematic. The investment in CTA managed accounts by institutions and investors with more complex money management programs that limited cash in excess of margin requirements has resulted in so-called "notional funds" to balance the difference between the program trading level and the actual cash on deposit with the FCM on a daily basis. Credit risk from exposure to FCMs with less net capital than the managed funds on deposit also is a factor causing investors to minimize cash on deposit with the FCM. On the other financial side, large investor cash deposits may increase the net capital requirements for FCMs beyond an efficient operational level.

In the entire 30 year history of the CFTC there have been only a few claims of misrepresentation or misleading performance reporting by CTAs. Enforcement actions by the CFTC and the National Futures Association ("NFA") related to the method of performance reporting are minuscule when compared to false advertising, misleading promotional material and other alleged violations of the Commodity Exchange Act, CFTC Regulations and NFA Rules. The need for revision is not a matter of investor protection, rather it is necessary to codify numerous formal and informal approvals granted on a case-by-case basis and to reconcile the rules with the reality of what investors are demanding. The CFTC has been very active during the last decade on studying notional funds and the emphasis on developing functional, uniform and informative reporting is recognized and applauded.

The NFA has also analyzed the situation from their long experience auditing performance reporting by NFA registrants, from discussions with industry representatives and dialogue with investors. Based on this knowledge and understanding of notional funds, the NFA has proposed Rule 2.34 requiring documentation of a notional funds agreement between an investor and a CTA. This initiative is the foundation for establishing, managing and regulating notional funds and the proposed CFTC Regulation 4.33 (c) adopts the provisions of proposed NFA Rule 2.34.

Performance Calculations

1. Federal Register Supplementary Information Part II, Sub-section I, page 12007 states "The Commission is not proposing to include the Only Accounts Traded Method as an option CTAs may choose prospectively due to concerns that it allows for accounts to be excluded entirely from the rate of return computation." The discussion goes on to say that the Commission will carefully consider proposals regarding any alternative method of addressing the effect of additions and withdrawals on the rate of return computation. We urge the Commission to adopt some of the

exclusions allowed in Advisory 93-13, particularly to eliminate from both the numerator and denominator those accounts opening or closing intra-month as such activity can materially distort the rate of return for a given month. This distortion would require the CTA to adopt the daily rate of return computation.

2. Proposed Regulation 4.35(a)(6)(i)(C)(1) requires that the rate of return shall be calculated for each trading day in the period and compounding each daily rate of return. An equally precise result (with far less work) occurs when the calculation is made only on the interval of an addition or withdrawal from the aggregate nominal account size. We urge the CFTC to consider the mathematical results from the two approaches and to allow calculation of performance data only when changes to the aggregate nominal account size occur.

3. Proposed Regulation 4.35(a)(6)(i)(C)(3) states that the rate of return shall be calculated by dividing the net performance by the nominal account size at the beginning of the period. Regulation 4.35(a)(6)(E) requires that a change in nominal size at the beginning of a period "shall be reflected at the end of the prior period." This requirement results in additions and redemptions being reported in the month prior to when such transactions actually occur. Rather than implement a system that records activity in the wrong period, it is suggested that additions and redemptions be reported in the month they occur and for purposes of defining the denominator for performance reporting, additions and withdrawals occurring as of the beginning of the month shall be adjusted in the denominator.

Capsule presentation
Res ipsa loquitur

Functionally, the objective of performance presentation is to communicate financial activity. A point I respectfully request the CFTC to consider is the adverse consequences of including risk disclosure in with financial data. Inserting artificial calculations in the capsule presentation to illustrate risk expands the data and decreases clarity. The reader of the capsule's financial data is better served if the actual historical numbers are allowed to speak for themselves in a clear and simple format. Another point of importance is the attention span for reading financial data. Soon after the first formal rules for performance reporting were released in May 1981, Arthur "Bugs" Baer and I met with the CFTC to discuss informative performance reporting. Bugs subsequently wrote to the CFTC explaining "Less is more" in effective communication. His philosophy is now widely accepted in many contexts and should be considered in requiring enough financial data, but not so much it becomes counter productive. An explanation of these points follows.

1. The CFTC has an important mission[1] of assuring that the investing public understands the risks of investing in commodities. In part, this is accomplished by requiring prominent and adequate risk disclosure to all prospective investors. This is accomplished with specified risk disclosure statements, required narrative discussion of the risks in the Disclosure Document, and again in the subscription agreement. A vast array of new risk disclosures related to partially funded accounts is required by proposed Rule 4.34(p). The requirement for yet another set of risk disclosure numbers in the performance reporting section of the document only adds clutter that will confuse many readers. The new requirement in Rule 4.35(a)(1)(ix)(B) for an additional column presenting another set of draw-down statistics based on the lowest level of funding below 100%, or at an arbitrary 20% if any account is a zero balance or below, will confuse more than inform.

[1] "to protect market users and the public from fraud, manipulation, and abusive practices related to the sale of commodity futures and options, and to foster open, competitive, and financially sound commodity futures and option markets."

2. Performance data is vital to understanding the money management experience of a trader. It is a challenge to refine the required presentation to effectively communicate key financial factors so the reader quickly obtains a clear understanding, but a task worthy of the time and attention to accomplish. Removing the requirement for an additional set of numbers irrelevant to the reader will improve the effectiveness of numerical disclosure.

3. Proposed Rules 4.35(a)(1)(viii)A & B require disclosure of the number of accounts that both opened and closed with a positive net lifetime rate of return and the range of such returns and the same information for accounts that closed with a negative net lifetime rate of return. The capsule data provides monthly performance data as well as separately stating the worst draw-down to highlight the worst past experience. The additional data on the experience of previous investors lacks sufficient importance to expand the capsule reporting. The reader can reasonably determine from the capsule what experience an investor might have had based on any selected time period within the 5 years displayed.

4. If Rules 4.35(a)(1)(viii)A & B are adopted, what is the effective date for capturing and reporting the closed account history? Is it prospective or must a CTA search five years of past performance and compile the information?

5. Presentation of the aggregate nominal account size is not required, yet this is the value used to calculate rate of return and provides other useful information on the relative amount of nominal funds. We suggest aggregate nominal account size should be included in the required capsule information.

Advisory Agreement

CFTC proposed Rule 4.33 will require a written agreement signed by each client, which specifies information of primary significance to partially funded accounts. The "Transitional Provisions" Section III, Fed. Reg. page 12007 states the documentation required by the new Rule 4.33(c) shall be obtained for both new *and existing* clients. We support such an agreement for all accounts whether fully or partially funded. However, we urge the CFTC to allow a flexible policy towards obtaining such agreements from existing investors. We ask the CFTC to specifically indicate that compliance will be satisfied if the existing investor agreements, monthly reporting to the investor, brokerage account statements, subscription agreements and Disclosure Document taken together as each may be relevant to a particular investor providing full disclosure of the status and nature of the investment account. Further support for this practical approach comes from the realization that any change in the nominal account size will require the specified documents and agreements, and the CTA can conform precisely to the new format at such time. This approach is consistent with the narrative in "SUPPLEMENTARY INFORMATION:" Section II B, explaining that CTAs would not need to use a separate agreement to respond to the new requirements, but could incorporate the requirements into their existing client agreements.

Disclosure Document

Proposed CFTC Rule 4.34 requires the following additional disclosures if partially funded accounts are offered:

- management fees as a percentage of nominal account size and effect of partial funding
- estimated range of commissions as a percentage of nominal account size and effect of partial funding

- statement that leverage is increased by partial funding and that the greater the difference between actual funds and nominal account size, the greater the likelihood of margin calls, as well as the percentage of actual funds represented by those margin calls
- Factors considered in determining the trading level for a given nominal account size

The disclosure that is most problematic is the commissions as a percentage of nominal account size and the effect of partial funding. The investor and the FCM often determine commissions and the CTA has an equal interest with the investor in minimizing commissions[2]. Commissions are a function of trading frequency, types of contracts traded and individual agreements and are not correlated with investor profits or losses as an indicator for CTA selection. In other words, many examples exist of a CTA with higher trading velocity and a higher commission rate having greater net gains to the investor than a trader with fewer round turns and lower commissions.

Core principles

Core principals allow flexibility that is important in dynamic situations such as the environment for commodity trading. However, discipline in reporting is essential to achieve a common understanding of the performance reports issued. Based on our long experience with commodity trading, we suggest the best approach is to adopt formal rules, yet not so specific or precise that they are unworkable in changing circumstances. A policy whereby the published Rules are a compliance safe-harbor and limited departure is allowed with the responsibility on the CTA to establish through clear and convincing evidence that such departure was consistent with the core principles and not misleading. An example is to allow existing advisory agreements for fully funded accounts that satisfy the objectives of notional fund disclosures, if not the precise text or terminology. Another example is to allow reduced disclosures in the required manner of proposed Rule 4.35(a)(1)(v), (vi) and (ix) to qualified eligible persons as defined in CFTC Rule 4.7, provided the information delivered presents fairly all necessary disclosures under the circumstances. Another example would be to allow a CTA to include an account in all reporting but omit from the ROR calculation if the account had a significant client imposed restrictions, such as not trading certain markets, and the restriction caused the account to differ from other accounts on a regular basis.

On behalf of CTAs, CPOs, investors and this firm, we thank the CFTC Commissioners and staff for the time and attention devoted to the important issue of performance reporting. The proposed changes will benefit all parties to the trading program. If you have any questions or would like to discuss any portion of this comment letter, Arthur F. Bell, Jr., Ross Ellberg or Debby Hallett welcome your call at 410-771-0001.

Sincerely,

/s/

Arthur F. Bell, Jr.

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[2] This comment is based on the almost universal situation where the CTA does not share in commissions. If the CTA does receive a portion of commissions, it must be disclosed under current rules.