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September 15, 1998 1998 SEP 16 P 12: 22

OFFICE OF THE SECRETARIAT

Via Overnight Mail

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

COMMENT

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COMMODITY FUTURES
TRADING COMMISSION
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Re: Performance Data and Disclosure for Commodity Trading Advisors and Commodity Pools; 63 Fed. Reg. 33297 (June 18, 1998).

Dear Ms. Webb:

National Futures Association (NFA) welcomes this opportunity to comment on NFA's notional funding proposal. NFA notes that the Commission's release also deals with several other issues. Although NFA recognizes the value of examining the other issues raised by the release, we do not believe that the NFA proposal — which has already been pending at the Commission for four years and the logic of which has been advocated by the industry for at least eleven years — should be held up while these other issues are being studied. Therefore, NFA urges the Commission to separate NFA's proposal from the other issues discussed in the release, to approve NFA's proposal quickly, and to give the industry adequate time to study and consider the remaining issues.

Introductory Comments

The Commission's release contains a number of apparent misconceptions about the use of notional funding. First, the Commission seems to think that notional funding is or will become a retail phenomenon. NFA is not aware of any widespread use of notional funding among unsophisticated clients. Rather, institutions and other sophisticated customers use notional funding for cash management purposes. Furthermore, NFA has many years of experience regulating CTAs, and we have not seen any abuses involving notional funding. Nonetheless, acknowledging the possibility that a few CTAs may use notionally funded accounts with unsophisticated customers, NFA's proposal does includes provisions intended to protect unsophisticated customers who may be solicited to, or otherwise decide to use, notionally funded accounts.

Second, the Commission's release assumes that CTAs dictate both the amount that the CTA will use as the basis for its trading decisions (nominal account size) and the amount of funds deposited with the FCM. In reality, the CTA does not have

unilateral control over the nominal account size and has no control at all over the amount of funds deposited with the FCM. The client — not the CTA — decides the amount it wants the CTA to base its trading decisions on (although the CTA has to agree to that amount), and the client — not the CTA — decides how much money in excess of margin requirements to deposit with the FCM. In fact, the only number the CTA cares about is the amount that the CTA and the client have agreed the CTA will use as the basis of its trading decisions.

Third, the release reflects Commission staff's apparent belief that all trading programs and commodity pools should use the same amount of leverage. For example, the release states:

> Nominal account sizes are not comparable from one CTA to the next. In discussions with representatives of the industry concerning this issue over the past ten years, it has become clear to the Commission staff that there is no method in common use in the industry relating the nominal account sizes to the number of positions traded. Indeed, NFA has reported that setting such levels "is inherently a subjective process" and "a matter of the CTA's judgement."

63 Fed. Reg. 33297.

The quote suggests that Commission staff is troubled by the fact that there is no method in common use in the industry relating nominal account sizes to the number of positions traded — in other words, no method for equalizing the amount of leverage that CTAs use. However, just as there is no common method for relating nominal account sizes to the number of positions traded, there is no common method for relating actual account sizes to the number of positions traded. This is simply not a notional funding issue.

The use of different amounts of leverage by CTAs is not the problem: it's the point. Different degrees of leverage among trading programs and commodity pools are both the common and the historical practice in this industry. This is, in fact, what the clients want. One trading program is successful at attracting clients who want a high degree of leverage, while another trading program attracts clients who want far less leverage. Equalizing the amount of leverage interferes with a client's ability to make a choice based on its own financial needs and philosophy.

Finally, the Commission's release is permeated with statements that notional funding creates increased risks for clients. For example, the release states:

> Since partially-funded accounts are more highly leveraged than fully-funded accounts, they will incur magnified gains and losses compared to fully-funded accounts. For example, a customer who is funding its account at 25% of the

> nominal account size will realize gains — and losses — at four times the rate experienced by a fully-funded client. A loss of 30% on a fully-funded basis will result in a loss of 120% of the investment of a customer which funds its account at 25% of the nominal level, wiping out the initial investment and leaving a deficit to be repaid by the customer.

63 Fed. Reg. 33297, 33299. In fact, the risk and the leverage are exactly the same for these two accounts. A $5,000 gain or loss is a $5,000 gain or loss regardless of whether it is 25% or 120% of the amount deposited at the FCM, and the amount of leverage is based on the trading program itself, not the funding level. The only difference that partial-funding makes is to increase the frequency of margin calls.

NFA's Proposal

On March 15, 1994, NFA submitted proposed Compliance Rule 2-34 to the Commission for review and approval. NFA's proposal was amended twice at the request of the Commission, and those amendments were submitted to the Commission on March 15, 1995 and February 26, 1998, respectively. The March 15, 1995 submission made several amendments to the language in Compliance Rule 2-34 and adopted an Interpretive Notice to further clarify that rule. The February 26, 1998 submission amended Compliance Rule 2-29(b)(5) to make it explicit that rates-of-return must be calculated using nominal account size as the denominator.

NFA's notional funding proposal was the product of NFA's Special Committee for the Review of CPO/CTA Disclosure Issues (Special Committee), which was appointed by NFA's Board of Directors. To ensure a broad range of perspectives, the Special Committee was composed of individuals from all areas of the managed funds industry, from prominent CPO and CTA Members to attorneys and accountants who practice extensively in this area to a public director of NFA. In addition, members of the Commission's staff were invited to attend the Special Committee's meetings.

The notional funding proposal is one of the most important proposals developed by the Special Committee. NFA's proposal is premised on the belief that the disclosure and sales practice issues associated with notional funding of accounts are best addressed through NFA Compliance Rules tailored to deal with those specific issues rather than through a tortuous interpretation of rules concerning how past performance information is calculated.

The Special Committee and the Board recognize the Commission's valid concerns regarding the documentation, disclosure, and sales practice problems that notional funding of accounts can create. Over the years, however, experience has shown that these concerns are not at their core computational issues and that addressing them through an interpretation of the definition of beginning net asset value (BNAV) is not the

most effective way to deal with them. NFA is convinced that the most effective way to handle these customer protection issues is by adopting an NFA compliance rule that extends the documentation and disclosure requirements in Commission Advisory 93-13 to all CTAs. Having dealt with the customer protection issues, the NFA proposal then requires all CTAs to calculate rate-of-return (ROR) based on the notional amount rather than the amount deposited as margin. NFA's proposal will require all CTAs to report their rates-of-return on a uniform basis, without the potentially distorted results or confusing multiplicity of tables allowed under the current regulations.

NFA's proposal is based on the premise that all similarly traded accounts should have the same ROR, regardless of the amount of funds on deposit with the FCM. ROR should accurately reflect the results of the CTA's trading decisions over time, not the clients' differing cash management strategies. Using actual funds on deposit as the denominator in the ROR calculation distorts performance by overstating both positive and negative returns. It also exaggerates the volatility of the trading program. NFA's proposal, on the other hand, calculates ROR using the amount the CTA bases its trading decisions on as the denominator, thereby reflecting the CTA's actual performance.

NFA notes that footnote 22 in the Commission's release states that NFA's proposal would appear to prohibit the presentation of worst month and peak-to-valley figures on a partially-funded basis. NFA's proposal would require CTAs to present this information based on the nominal account size, regardless of the funding level. NFA's proposal would not, however, prohibit CTAs from reporting worst month and worst peak-to-valley figures based on the amount of funds on deposit. NFA can clarify this issue in an interpretive notice if the Commission believes it is necessary.[1]

Response to the Commission's Request for Comment

A. *Disclosure of Risk Profile Data on CTA Programs for Clients Considering Participation on a Partially-Funded Basis.*

The Commission's release states that, "It is important to convey to investors, as clearly as possible, that partially-funded participation in a CTA program will result in proportionately greater volatility — and proportionately greater drawdowns — compared to a fully-funded participation." 63 Fed. Reg. 33297, 33300. NFA does not agree that a

[1] Footnote 22 also states that "The NFA Proposal would appear to prohibit the presentation of ROR figures based on any of the 'actual funds' methods required in Commission regulations or permitted in Advisories 87-2 and 93-13." (Emphasis added.) As the Commission appears to recognize in footnote 20, it is the Commission's Advisories, rather than Commission regulations, that require a particular method of determining BNAV, which is the denominator for the ROR calculation.

trading program has different degrees of volatility for different funding levels. Although the percentage drawdown may be different, the volatility is not.

NFA understands that drawdown percentages based on different funding levels may provide some useful information to clients. However, clients already have, and will continue to have, all of the information necessary for calculating these percentages. The sophisticated clients who use partially-funded accounts are perfectly capable of doing their own math if they want this information.

If the Commission believes that drawdown percentages at different funding levels should be required, NFA agrees with the statement in the release that the information should be conveyed as clearly as possible. This could be done by requiring several numerical examples for funding levels frequently used by the CTA's clients to be given immediately following the current performance capsule. What the Commission should definitely not do is require a matrix that makes clients' eyes gloss over and, therefore, would not be read and, if read, would tend to confuse rather than clarify.

B. Presentation of Data Concerning Margin Rates

The release notes that NFA's proposed Rule 2-34(b)(1) requires CTA's to disclose to non-QECs "an estimated range of the amount of customer equity generally devoted to margin requirements or option premiums, expressed as a percentage of the nominal account size of the accounts traded by the CTA, and an explanation of the effect of partially funding an account at that percentage." The release characterizes this requirement as being intended to provide a measure of risk and to help clients understand how partial funding increases risk.

The Commission's characterization of proposed Rule 2-34(b)(1) is incorrect. As discussed above, funding level does not affect risk. It does, however, affect the frequency of margin calls, and that disclosure is required by proposed Rule 2-34(b)(4).

NFA adopted proposed Rule 2-34(b)(1) in response to concerns raised by Commission staff that the CTA would set a nominal account size that bore no relation to how the account is traded and was intended solely to distort the CTA's performance. As NFA stated above, the client (with the consent of the CTA) sets the amount the client wants the CTA to use as the basis of its trading decisions, and this amount must be agreed to in writing. Nevertheless, NFA's proposal includes several checks to ensure that the nominal account size is not an arbitrary number that varies from client to client. Disclosing the general range of margin requirements is one of these measures. If the CTA's trading regularly requires margins that are either higher or lower than the range estimated by the CTA, both the client and NFA will be able to question whether the CTA is in fact using the trading program the client agreed to.

The Commission's release asks if "an estimated range of equity generally devoted to margin" is itself an arbitrary measure and whether CTA's should be required to disclose an absolute upper percentage of customer equity that will be devoted to margin. NFA believes that the information required in proposed Rule 2-34(b)(1) is as close as anyone can get to measuring the amount of margin required by a particular trading program. Given the nature of the futures markets, the CTA must be given flexibility to set this range and should not be held to it under unusual market conditions. This does not mean that the CTA can choose the range arbitrarily without any checks and balances. NFA will look at the range when reviewing the disclosure document . If the range is so wide as to be uninformative, NFA will ask the CTA to revise it

C. *Providing the CTA/Client Agreement to the FCM*

NFA's requirement to provide the FCM with a copy of the agreement between the customer and the FCM is taken from Commission Advisory 93-13, which requires CTAs with partially-funded accounts to supply the carrying FCM with each partially-funded customer's nominal account size. NFA's proposal goes farther than Advisory 93-13, however, by requiring CTAs to provide the FCM with copies of agreements showing the nominal account size for all of the CTA's clients, not just those who use partially-funded accounts. Providing these agreements on an exception basis, as Advisory 93-13 requires, increases the likelihood of miscommunication in that it does not give the FCM any reason to know that an account is partially-funded if the CTA fails to supply a copy of the agreement. NFA's proposal increases the amount of information available to the FCM when assessing the creditworthiness of the client.

D. *Presentation of Risk Profile Data on Commodity Pools*

NFA's proposal also requires certain CPOs to provide pool participants with a statement of the total amount allocated to a pool's CTAs as a percentage of the pool's net assets. This information is only required for those non-QEP pools that allocate assets among the pool's CTAs in such a way that the total allocations to its CTAs is greater than the total assets of the pool. The Commission has also asked for comments on this requirement.

The Commission's release again misunderstands the nature of NFA's proposal. The percentage figure required by NFA's proposal is not designed to aid prospective participants in comparing one commodity pool to another or to be a precise measure of risk, but only to show the degree of leverage used by the particular pool. Simply stated, different pools have different degrees of leverage, and the prospective pool participant should know the degree of leverage involved in a particular pool before investing. This has been the Commission's consistent position, and it is one that NFA fully agrees with.

The release goes on to request comment on "an alternative approach to enhancing the presentation of risk profile data for pools." 63 Fed. Reg. 33297, 33301. NFA agrees that a more accurate measure of a pool's risk profile could be helpful to prospective investors. Over the years, a number of people have suggested requiring pools to use a standardized risk measure, such as the Sharpe ratio, although the merits of particular measures have been sharply debated. This is an issue that is worth exploring and one that the Special Committee is currently considering. NFA urges the Commission to separate this issue from NFA's notional funding proposal and give the Special Committee time to complete its evaluation.

In any event, the alternative approach suggested by the Commission in its release is unworkable. First, it measures the wrong thing. A pool's risk profile should be based on the pool itself, not on the individual CTAs or investee pools, some of whom — under the approach suggested by the Commission — are no longer even part of the pool's current mix. The Commission's approach is analogous to measuring a mutual fund's risk by looking at the volatility in the stocks the mutual fund held a year ago. Second, the alternative approach suggested by the Commission is cumbersome, incomprehensible, difficult to administer, and of limited use.

E. Theoretical Soundness of the Basis of Computation and Presentation for ROR and Related Risk-Profile Data

As the Commission recognizes in its release, NFA's proposal does not require CTAs to maintain any fully-funded accounts. In contrast, in order to use the fully-funded subset rather than the actual accounts method of calculating and reporting ROR, Advisory 93-13 requires fully-funded accounts to make up at least 10% of the aggregate account size. The Commission's release questions whether NFA's approach is appropriate.

The rationale behind the Commission's requirement that a CTA have a certain number of fully-funded accounts before it can use the fully-funded subset method of calculating ROR is to ensure that there will be a benchmark for comparison purposes. Under NFA's proposal, the benchmark measure is all similarly situated accounts: i.e., whether all accounts in the same trading program with similar nominal account sizes (as stated in the agreement between the CTA and the client) are getting the same trades and have the same performance. Under NFA's proposal, the benchmark is eminently auditable, the method used is not subject to hindsight, and the level of performance reflects the CTA's trading decisions rather than the client's cash management strategies.

The first question posed in this section of the release asks if the fully-funded subset requirement should be retained to validate the nominal account sizes used by the CTA. NFA's answer is a resounding "NO." As stated above, the fully-funded subset is not needed to validate the nominal account sizes. Furthermore, the number of fully-funded accounts that use the CTA's trading program is not within the CTA's control. The law

prohibits CTAs from holding customer funds. As mentioned earlier, the client, not the CTA, decides how much, if any, excess margin to deposit with the FCM. The only figure the CTA cares about is what amount the client wants the CTA to base its trading decisions on, which is the nominal account size under NFA's proposal.

The Commission staff appears to believe that, without a fully-funded subset, CTAs will use an arbitrary nominal account size intentionally selected to distort their performance or mask the volatility in their managed accounts. NFA questions the assumption that a CTA would choose to establish artificially high nominal account sizes in order to mask volatility. In NFA's experience, we have seen far more abuses involving inflated RORs than artificially depressed volatility. The actual funds method currently in use feeds these abuses by inflating ROR for marginally profitable, as well as highly successful, CTAs. NFA's method will not. We also note that there is no evidence that CTAs intentionally use nominal account sizes to decrease their RORs. Nevertheless, NFA's proposal contains several safeguards to discourage CTAs from choosing nominal account sizes in order to distort performance or mask volatility. First, the client must agree on the nominal account size. Second, the margin ratios must generally be consistent with the disclosures made by the CTA.

This section of the Commission's release also suggests that the current methods of computing ROR, and particularly the fully-funded subset method, are consistent with Generally Accepted Accounting Principles (GAAP) and implies that NFA's proposed method is not. However, not every matter that involves a mathematical calculation is at heart an accounting issue, and NFA is not aware of any GAAP pronouncement that addresses how to calculate BNAV or ROR. Furthermore, NFA's Special Committee included two highly respected industry accountants, and they both agreed with NFA's approach. During the Financial Products Advisory Committee meeting on June 11, 1998, another prominent financial industry accountant stated that this is not a GAAP issue.

NFA also notes that the Association for Investment Management and Research (AMIR) has specifically addressed the use of partially-funded futures accounts managed by professional advisors and adopted an approach that is entirely consistent with NFA's proposal. NFA's August 24, 1994 letter to David Van Wagner of the Commission's staff contains a more complete discussion of the AMIR position.

F. Changes in the Presentation of Historical Data

The Commission's release poses several questions about the way that CTA historical data is presented. NFA believes that these are valid questions to ask. In fact, NFA's Special Committee is currently examining the information that is provided to prospective and current CTA clients. NFA believes that these questions, which are not

notional funding issues, should be separated from NFA's proposal to allow the industry more time to study them.

The Special Committee believes that adding more drawdowns to the historical data presented in the performance capsule should be explored. NFA and the Special Committee are very mindful, however, that in many instances less is more in disclosure documents and that the Commission, NFA, and the industry should always weigh the incremental value of adding more information against the possibility that the information will dilute the impact of more significant disclosures. For example, NFA has always felt that monthly rates-of-return provide too much information to read and absorb while adding little value. Adding several additional drawdowns to the performance capsule may well be an appropriate *quid pro quo* for eliminating monthly rates-of-return. We believe that this issue needs to be studied, and NFA's Special Committee is prepared to do so.

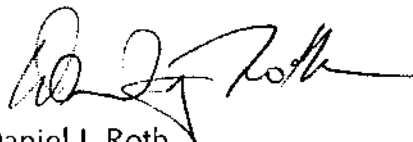
C. *Keeping Clients Regularly Informed Regarding CTA Program Status*

The Commission seeks comment on whether CTAs should send periodic reports to clients regarding account fees, the basis of incentive fee calculations, and the current nominal account size. NFA believes that this information is unnecessary. All of the information listed in the release is either already reported to the client or can be derived from information the client already receives. Furthermore, NFA has never had a customer complain that the information currently required for a managed account is inadequate.

Conclusion

In conclusion, NFA urges the Commission to promptly approve NFA's proposal and to separate the other issues in the release from NFA's proposal for further study and comment.

Respectfully submitted,



Daniel J. Roth
General Counsel

(kpc\committe\Notional Comment Letter)