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September 21, 1998

COMMENT

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

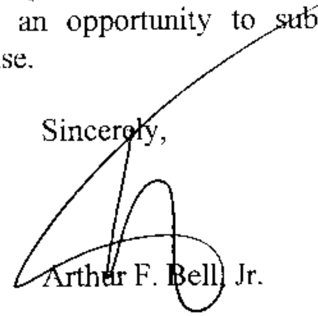
FACSIMILE (202) 418-5221

Re: Performance Data and Disclosure for Commodity Trading Advisors and Commodity Pools; Volume, Number 117 63 Fed. Reg. 33297 – 33304 (June 18, 1998).

Dear Ms. Webb,

We were unable to comment within the allowed time requirement on the above Concept Release and requested in a letter to you on September 15, 1998 an opportunity to submit our comments on September 21, 1998. The attached Word file is our response.

Sincerely,



Arthur F. Bell, Jr.

COMMODITY FUTURES TRADING COMMISSION
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September 21, 1998

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

email: secretary@CFTC.gov
FACSIMILE: (202) 418-5221

Re: Performance Data and Disclosure for Commodity Trading Advisors and Commodity Pools; Volume 63, Number 117, Fed. Reg. 33297 – 33304 (June 18, 1998).

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) "Request for Comments" on the Concept Release identified above.

Arthur F. Bell, Jr. & Associates, L.L.C., is a Certified Public Accounting firm serving the futures industry for approximately 20 years. The firm has over 200 clients involved in derivative and equity trading as Commodity Trading Advisors ("CTA"), Commodity Pool Operators ("CPO"), Futures Commission Merchants ("FCM"), Introducing Brokers ("IB"), Registered Investment Advisors ("RIA") and similar capacities. Members of the firm are involved in numerous industry committees, and Mr. Bell is a member and former Director of the Managed Funds Association ("MFA") and is a member of MFA Government Relations Committee, Futures Industry Association ("FIA"), National Futures Association ("NFA") Special Committee, the CFTC Global Markets Advisory Committee, the UK Pension Research Accounting Group, Advisory Panel of Futures Industry Law Letter and various other similar industry groups. The firm's experience and industry involvement are the bases for substantial interest in the Concept Release.

We recognize and respect that the CFTC Division of Trading and Markets has carefully considered notional funding of accounts as far back as CFTC Advisory 87-2 (CCH ¶ 23,264) and has carefully and patiently listened to a continuous parade of interested parties passionately arguing for changes to the CFTC rules for reporting performance. The need for accommodation was recognized and Paul H. Bjarnason, Jr., Chief Accountant, CFTC, drafted the basis for what became CFTC Advisory 93-13, 58 Fed. Reg. 8226 (February 12, 1993). This relief is widely used by numerous CTAs and functions satisfactorily in many situations. However, the conflict of trying to measure both a CTA's trading program results and a particular investor's rate of return via a single rate of return calculation remains unsolved and the source of substantial concern. For a long time we subscribed to an accounting concept that cash was required to determine the denominator in the rate of return calculation. This position was based on the belief that:

- Discipline was required in the denominator
- Independent determination of the account size was essential
- Uniformity of method of calculating performance was required for all CTAs
- The rules had to be clear enough to allow compliance enforcement
- The rules should not provide an opportunity for improper sales practice
- The rules should not allow subjective shuffling of the data by a CTA
- Any change could not risk the integrity of the marketplace by encouraging excessive leverage
- Proper disclosure must be developed and presented in the performance tables or Disclosure Documents

The present permitted methods of calculating rate of return are not responsive to the industry practice and often develop misleading results, which the CTA must modify at the risk of violating regulatory requirements. This situation must be revised, and we commend the Chairperson, the Commission and staff for the development of this Concept Release.

We participated on the NFA Special Committee that worked with industry professionals and the CFTC to respond to concerns such as the ones identified above and other factors to provide "discipline in the denominator." The result of this multi-year process resulted in a submission to the CFTC on February 26, 1998 of NFA Compliance Rule 2-29(b)(5) to allow rates of return for CTAs to be based on the nominal account size as described in NFA Compliance Rule 2-34, "the NFA Proposal." We now believe that approval of the NFA Proposal is necessary to provide a reasonable, uniform and enforceable method to calculate and report CTA rate of return. The NFA Proposal provides an answer to the concerns listed above that improves reporting, market integrity and investor protection.

General comment on "SUPPLEMENTARY INFORMATION: II. Discussion A. Rate-of-Return"

The Concept Release discusses in this section the current CFTC requirements "for the presentation of rate of return data based upon the 'return on investment' ('ROI') concept used by economists, financial analysts and other professionals throughout the business world...." The text further states that "in all areas outside of commodities trading the divisor used in the calculation of ROI are amounts of actual cash funding...." The Association for Investment Management and Research ("AIMR") challenges the suggestion that economists and accountants use the same definition. The *AIMR-PPS Standards*[1] contains the following explanation:

> two universally accepted definitions of leverage in the investment context - the accounting definition and the economic definition - are used. One definition may be more appropriate than the other in a specific case. An *accountant* would say that leverage results when total assets are greater than net assets - that is, when some part of the assets is financed by liabilities, or borrowing. An *economist* (or perhaps a portfolio manager) would say that leverage results when supplementary investment actions are taken to generate returns from an unleveraged benchmark portfolio.

A second and different challenge to the statement that commodities are an "all cash" investment is to simply realize that commodities trading is inherently a no cash contract between investors. Margin is required by the intermediaries (the exchanges) and the regulators as a credit risk safeguard since the underlying contracts require no cash. Thus, commodities trading is inherently and unalterably different from other investments, and therefore notional funding already exists before the traders and investors establish their subjective cash requirements. The cash flow consequences of commodities are even more bizarre - the margin allowed in the contract is interest free and an investor with a profit can collect his gain (in excess of margin) without selling his contract and without reporting a taxable transaction.

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[1] Association for Investment Management and Research, *Performance Presentation Standards Handbook, Second Edition* (Charlottesville, 1996), 117.

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

An issue of concern to accountants is the burden of extraneous disclosures in financial reports and performance presentation. We support disclosure of relevant material information, but advocate including risk disclosure items in the narrative section of a Disclosure Document or promotional material and not a required disclosure in performance table footnotes. We strongly urge the Commission to distinguish between risk and compliance disclosure items and footnotes necessary to explain a historical performance table.

We do not believe that providing disclosure of drawdown data at various funding levels will provide any additional benefit to readers of performance presentation tables. The Commission wishes to explore in Question 1 the costs and benefits of requiring multiple funding level drawdown data. The cost to construct such a table is negligible, but the more extraneous numerical data presented the less attention given by the reader. The real cost of data overload is that it is ignored by its intended audience. The NFA's Proposal would require drawdown data to be presented based on nominal account size, regardless of the funding level. Our experience is that clients who use partially-funded accounts are sophisticated investors who understand the effects of partially funding their accounts. The FCM will also consider the credit risk and sophistication of an investor in determining suitability for a commodities account since the risk of loss falls on the FCM if the investor fails to satisfy cash requirements. This information is readily apparent in the matrix which is currently required. It is our opinion that providing drawdown data at various funding levels is unnecessary, provides no added benefit, and contributes to excessive information in the document. Further, we believe that it is not a precise means of disclosing the effects of various funding levels. For example, accounts which are less than 100% funded earn less interest than fully-funded accounts. As to Question 2, if additional disclosure on the risks of partially-funded accounts is deemed absolutely necessary, the most effective format is succinct text disclosure and not additional mathematical models.

B. <u>Presentation of Data Concerning Estimated Margin Ratios</u>

The NFA's proposed Rule 2-34(b)(1) requiring CTAs to disclose "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" was not meant to be an indicator of risk or volatility. We do not believe that margin requirements are reliable indicators of risk. In fact, we believe that it is a potentially misleading implication.

Question 1: We supported inclusion of the margin to equity ratio requirement in the NFA Proposal as an indicator of the minimum funding requirement for a particular CTA trading program and as one indicator of exposure to additional margin calls.

Question 2: There is no known evidence to us of any relationship between margin and risk. CTA Disclosure Documents contain several pages of risk disclosure, expanding with each successive issuance to add yet another risk discovered and disclosed by some other CTA, as though there is some industry contest to identify and explain the most risks. The difficulty of identifying risk is illustrated by the story of two wilderness explorers who encounter a deep and dangerous gorge with an existing but ancient footbridge across to the other side. As they needed to cross the gorge, in an attempt to minimize risk they pulled on the old bridge to determine its strength and, persuaded of its safety, attached harnesses and ropes to themselves and anchored them to adjacent trees as a means to catch themselves should they fall. Certain of their preventive risk measures they in fact safely crossed to the other side only to be met by a lion who devoured them. Risk comes in many ways and margin deposit is an unsatisfactory guide.

Question 3: The margin requirement disclosure is intended by the NFA Proposal as a limited benefit bit of information precisely because of the wide experience range in actual trading.

Question 4: A CTA cannot "commit to an absolute maximum margin" because of the numerous factors outside a CTA's control that could expose the account to substantial loss. In fact, we suggest the CFTC should *prohibit* such a commitment!

Question 5: The proper structure is to disclose risk, volatility, margin requirements and other relevant investment considerations in the narrative section of the Disclosure Document properly indexed and highlighted. The disadvantage of including risk disclosure in performance presentation is that the importance is diminished when it is reduced to footnote disclosure and is an extraneous overload to a concise explanation of the material elements of performance presented in a table or capsule.

C. Providing the CTA/Client Agreement to the FCM

It is our understanding that some FCMs do not normally obtain a copy of the CTA/client agreement. These FCMs do not want to obtain this agreement because they do not want to be deemed to be conducting business directly with the CTA. They claim their customer is the CTA's client, not the CTA, and they do not want to become a middleman. We are also familiar with FCMs who believe that providing the FCM with more information is better. We support the NFA Proposal to provide information about the client relationship and trading program, but discourage providing a copy of the CTA/client agreement to the FCM carrying the customer's account since it may contain confidential information.

Question 1: Currently, not all FCMs consider the nominal account size relevant; those who do can demand the information without a regulatory requirement and if not obtained, decline to accept the account.

Question 2: Each FCM has developed methods to determine anticipated trading level and expected minimum margin requirements. Also, an FCM can demand additional deposits before accepting trades or while carrying positions.

D. Presentation of Risk Profile Data on Commodity Pools

We do not believe that the NFA's proposal to disclose the total amount of nominal account sizes allocated to a pool's CTAs as a percentage of the pool's net assets was meant to provide any indication of risk or as a way of comparing one commodity pool to another. Please note that in our preface we stated that notional funds was an issue of discipline in the denominator. Regardless of the amount of leverage or notional allocations employed by a pool, the net asset value remains the same and the divisor is a constant with the related consequence on rate of return. Why is this true and acceptable? Because a pool is an *investor,* not a CTA. The desired measurement is the return to the pool, not the trading program of a particular CTA.

Question 1: It is factually correct that a leveraged pool has some increment of risk greater than the same pool identically structured with less leverage. It is also true that, depending on the structure, a fund with notional allocations may have less risk than another fund without notional allocations. Therefore, logic concludes that risk in pools (or the same pool with a different structure) cannot be equitably compared by measuring the amount of notional allocations in each pool.

Questions 2, 3 & 4: Much discussion occurs in the Concept Release about risk, but risk is not defined. The word "risk" derives from the early Italian *risicare*, which means "to dare." Webster's *New Illustrated Dictionary* explains risk as "a chance of encountering harm." A more applicable definition is found in Robert P. Rotella's excellent book *The Elements of Successful Trading*,[2] where risk is defined in the following way:

> **Risk** *is the amount and probability of an adverse or series of adverse events occurring.*

The lesson learned from studying these definitions is that risk in a trading program is a constant wholly independent of the amount of cash on deposit.

The discussion of risk measurement in pools is an altogether separate topic from measuring performance data, the primary topic of the Concept Release. Required disclosures in a CTA or Pool document were thoroughly considered prior to 1995 and vast changes to the Part 4 Regulations were adopted in 1995. If the CFTC wants to consider the merit, effectiveness and suitability of the 1995 Part 4 revisions, a study should be undertaken with the cooperation of the NFA, industry registrants, professionals active in this area, academics and investors. In any case, performance presentation and footnote disclosure should not be expanded to encompass and attempt to answer these questions. The items suggested in this question are entirely useless and counterproductive in reporting actual historical performance.

The analysis of risk is an important area of academic study, but before the CFTC and NFA attempt to provide the ultimate safeguard to investors by requiring massive statistical data, the following story from Peter L. Bernstein's book *Against the Gods*[3] should be considered to understand the imbalance between perception and reality:

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[2] Robert P. Rotella, *The Elements of Successful Trading* (New York: New York Institute of Finance, 1992),397.

[3] Peter L. Bernstein, *Against the Gods: The Remarkable Story of Risk* (New York: John Wiley & Sons, 1996), 116.

> One winter night during one of the many German air raids on Moscow in World War II, a distinguished Soviet professor of statistics showed up in his local air-raid shelter. He had never appeared there before. "There are seven million people in Moscow," he used to say. "Why should I expect them to hit me?" His friends were astonished to see him and asked what had happened to change his mind. "Look," he explained, "there are seven million people in Moscow and one elephant. Last night they got the elephant."

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

We do not believe that the fully-funded subset requirement should be retained. It is a reality that more and more investors are partially funding their accounts. The focus of rate-of-return computations should be on CTA performance, not on the client's cash management strategies. With proper documentation of account size, basing rate of return on nominal account size is the most accurate measure of a CTA's performance. We recognize the potential for abuse but believe that it can be overcome with appropriate administrative and enforcement provisions. The theoretical basis for calculating rate of return using nominal account size is that it represents the trading decisions of the advisor. The CTA and the client agree on the trading level. The cash management strategies of the client should not affect how the CTA determines the performance of his trading program.

The following is a comment on Advisory 93-13 and the fully-funded subset method of computing rate of return: During the six year interval from 1987 to 1993, the industry struggled with trying to comply with Advisory 87-2. The consequences included two tables (required and optional) for the same performance with two rate-of-return numbers and the CTAs constantly complaining that the required method was inaccurate and materially misleading. Industry passion over the problem was so intense that notional funds acquired the nickname "emotional funds." A dedicated and sincere initiative was undertaken by the CFTC under the leadership of Paul H. Bjarnason, Jr., to resolve this issue. The result was Advisory 93-13, which was received with some criticism because it did not provide the full relief desired by some members of the industry. The fully-funded subset method is the most prevalent method of calculating rate of return in use today, and some of the traders who use and benefit from Advisory 93-13 are nonetheless vocal critics of the method. In our opinion, Advisory 93-13 was a vital evolutionary experiment that has proven successful and is the foundation for taking the next step. Consider the pioneering elements in Advisory 93-13:

- Qualitative assessment of performance
- Quantitative measurement of performance
- Required matrix to illustrate leverage
- Required comprehensive notional account documentation
- Allowed 90% of accounts to be notional with just a 10% validating benchmark
- Recognized the inherent difference in new accounts, accounts with material additions and withdrawals and allowed their temporary exclusion from performance calculation
- Permitted presentation of a Beginning Net Asset Value ("BNAV") with and without notional funds

Experience has shown that notional funds parallel comparable fully funded accounts at the gross trading profit level. Compliance with the provisions has been excellent and the few violations of performance reporting during the 5 years since Advisory 93-13 stemmed from abuses and conduct unrelated to relief permitted in the Advisory. We were enthusiastic about the Advisory during development and release and remain impressed with its utility in many situations. The success of the Advisory encourages acceptance of the NFA Proposal, which will allow measurement of a CTA trading program without the distortion caused by basing performance measurement on a subjective funding level. The NFA Proposal results in calculations based on a broader base and, importantly, accommodates those who might not qualify for Advisory 93-13 because of various technical requirements.

Question 1: The success of the fully-funded subset method allows it to be discontinued and replaced by the NFA Proposal. Allowing multiple methods can be detrimental and Advisory 93-13 should be retired.

Question 2: The suggested inflation of the denominator in the example presented correspondingly reduces the rate of return, a critical measure of success for a CTA. Fully-funded account sizes are arbitrarily set by the CTA and therefore could be manipulated if such was the goal of the CTA. Misleading sales practices can be enforced independent of notional fund calculations.

Question 3: This question includes many facets. First, one must accept that the proper item to be measured is the CTA program performance, not the ROI obtained by various investors based on their arbitrarily selected funding level. Next, the proper economic and accounting theory applicable to this situation should be based on the perspective of the CTA trading program, not the investor's account and financial status since the investment account could be subject to Generally Accepted Accounting Principles ("GAAP"), whereas the performance tables are not subject to GAAP. Consider the authoritative literature. According to AICPA Professional Standards AU 623.02, the term "*financial statement*" refers to

> a presentation of financial data, including accompanying notes, derived from accounting records and intended to communicate an entity's economic resources or obligations at a point in time or the changes therein for a period of time in conformity with a comprehensive basis of accounting.

Note that performance tables are not financial statements and therefore are not technically subject to GAAP and can not be audited under Generally Accepted Auditing Standards ("GAAS"). Performance tables are also outside the scope of Other Comprehensive Basis of Accounting ("OCBOA").

A framework for accounting reports outside the scope of historical financial statements is found in the "Statements of Standards for Attestation Engagements" ("SSAE"). References to "financial statements" and "generally accepted auditing standards" are omitted from the attestation standards. Accounting reports issued under SSAE may be identified as an "examination," but not an "audit." Since performance tables are outside the scope of GAAP, broadly attaching GAAP requirements to them is inappropriate. It is appropriate to specify that certain aspects and concepts of GAAP, such as the accrual method of reporting, shall apply to performance tables. Also, government regulations may proscribe a basis of accounting that satisfies the needs of those who will use the information and to establish financial safeguards. For example, regulations for an FCM contain complex requirements to determine regulatory net capital and there appears to be no barrier for the CFTC to procedurally adopt new rules to calculate BNAV for purposes of calculating rate of return. The argument for notional funds is to allow a meaningful BNAV.

Question 4: Question 4 asks where notional funds fit into the broader world of financial services and the ability to make fair comparisons. In response, we will quote other recognized authorities.

The London-based Futures and Options Association ("FOA") developed industry standards for performance reporting by fund managers that was accepted by the British Securities and Futures Authority. After consultation with industry professionals and the CFTC, the FOA issued "*Guidance on Performance Reporting*[4] in 1996. The following section states the view on notional funds:

> The FOA is of the view that performance reporting is designed to give existing and potential customers information on the trading ability of a DFM [Derivative Fund Manager] and therefore funds under management should comprise the amount traded by the DFM, irrespective of the amount deposited by customers.

Beverly Chandler, an award winning financial journalist who has written for the *Financial Times*, the *International Herald Tribune*, the *Independent*, the *Guardian*, the *Daily Express* and numerous industry journals wrote in her book *Managed Futures*[5]:

> Performance results are meaningful only when a universal reference, standard or procedure exists to quantify and measure financial activity.

Jack D. Schwager, author of *Market Wizards* and numerous authoritative texts on managed futures trading, responds to the dilemma of actual versus notional funds in his book *Managed Trading*[6] *as follows:*

[4] Futures and Options Association, *Guidance on Performance Reporting by Derivative Fund Managers* (London, 1996), ¶ 4.5. Arthur F. Bell, Jr., is a contributor acknowledged in the FOA guideline report.

[5] Beverly Chandler, *Managed Futures: An Investor's Guide* (Chichester: John Wiley & Sons, 1994), 63. Arthur F. Bell, Jr., is a contributor to the book and acknowledged in the text.

[6] Jack D. Schwager, *Managed Trading: Myths and Truths* (New York, John Wiley & Sons, 1996), 23. Arthur F. Bell, Jr., is a contributor to the book and acknowledged in the text.

In the case of partially funded accounts, the question then becomes, should rates of return be based on actual funds alone or on actual funds plus notional funds? There is only one reasonable answer: *Insofar as return levels should reflect only a CTA's performance and not the portion of funds deposited by the investor, return calculations should be based on actual funds plus notional funds.*

F. Changes in the Presentation of Historical Data

The CFTC's part 4 Regulations went through a major rewrite in 1995. We believe that substantial consideration was given to the presentation of historical data at that time. We believe it is too soon to broadly revisit this issue. We also believe that this issue should be allowed to evolve and that more time is needed before the effects of the CFTC's historical data presentation can be better understood. We strongly urge a study to determine sufficiency of disclosures and a need for revision prior to modifying requirements. We believe the examples of additional disclosure in the Concept Release are available and provided in the rare occasions when requested by investors and no changes are necessary at this time.

G. Keeping Clients Regularly Informed Regarding CTA Program Status

We believe that clients receive the information that they need and want on a timely basis. We have received no indication that clients are unsatisfied with the data which they are receiving. Clients receive timely statements from their FCM which shows all trading activity and we believe that if they request any additional information from the CTAs, the CTAs, as sound business men and women, will provide whatever additional information is requested. We believe that this is an example of "If it ain't broke, don't fix it."

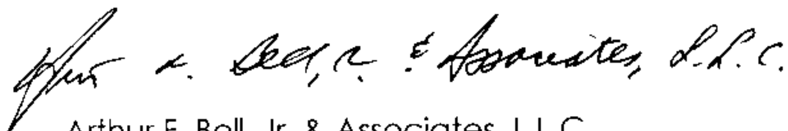
We note with appreciation and support Commissioner Tull's Statement in the Concept Release. For those who have argued ten long years for these changes, for those who consider approving change and for those opposed to change – we offer the following quotes:

"To every thing there is a season, and a time to every purpose under the heaven."- Ecclesiastes 3:1

"It were not best that we should all think alike; it is the difference of opinion that makes horse races."- Mark Twain, *Pudd'nhead Wilson*

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

Sincerely,



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