

electronic mail to secretary@cftc.gov. Reference should be made to "Performance Data and Disclosure for Commodity Trading Advisors."

FOR FURTHER INFORMATION CONTACT:

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SUPPLEMENTARY INFORMATION:

I. Background

The Commission is proposing to amend several of its rules¹ affecting the computation and presentation of rate of return information and other disclosures by CTAs to prospective clients. The proposed amendments will enable CTAs to disclose past performance as computed on the basis of the client's nominal account size (the amount upon which the CTA bases its trading decisions) rather than on the basis of the actual funds the client has placed in an account subject to the CTA's control. The amendments will affect past performance disclosure made by CTAs to prospective clients, and will not affect the manner in which information is provided to existing clients. Existing clients will continue to receive information on the status of their own accounts on an actual cash basis.²

On August 2, 1999, the Commission published in the **Federal Register**³ proposed rules regarding the computation and presentation of rate of return information and other disclosures concerning past performance of accounts over which the CTA has had trading authority.⁴ No final action was taken at that time. Now, due to the passage of time, intervening legislative and other developments, including

reevaluation of certain of the issues involved, the Commission is republishing these amendments.

II. Proposed Amendments to Commission Regulations 4.25, 4.33, 4.34 and 4.35

A. Rate of Return Computation

This proposal addresses how to measure advisors' rates of return in a margin- and leverage-based industry. From the CTA's perspective, trading is the same for all accounts in a program, regardless of the amount of actual funds. The use of margin, however, allows clients to fund accounts with much less in actual funds than the account size that they have agreed to have the CTA trade. Determination of the amount a client deposits with an FCM is between the FCM and the client—the CTA is not part of this decision, nor does it affect the CTA's level of trading for the client's account. Each existing CTA client will receive from its FCM reports of the amount of actual funds in the account, the profits or losses that occur, fees charged, and notice of any margin calls that may be necessary.

The rules that the Commission is proposing to revise apply to the disclosure of the CTA's past performance to prospective clients. The difficulty in basing such performance on actual funding levels arises primarily from the use of margin, which permits actual funding levels that may be so minimal as to make a return calculated on that basis greatly distorted. In addition, clients generally may open accounts with an FCM of their own choosing and clients in the same trading program may, in fact, have widely divergent amounts of actual funds supporting the same level of trading. In order to allow CTAs to present to prospective clients composite performance results that will be consistent for the accounts within the program, the Commission is proposing that the basis for the rate of return calculation be the amount on which the CTA is making its trading decisions—the nominal account size.

1. Brief History of Methods Used To Compute Rates of Return

The Commission first required disclosure of the past performance of CTAs in 1981.⁵ The rate of return for a period for a particular trading program

was defined as the net performance⁶ for that period divided by the net asset value at the beginning of the period.⁷ At that time, the practice of partial funding was not common; clients generally deposited in their accounts with FCMs an amount equal to the amount that the CTA and its customer had agreed would determine the level of trading, which subsequently became known as the "Nominal Account Size."

In later years, Commission staff became aware that some CTA clients were not depositing the full nominal account size in their FCM accounts. This led the Division of Trading and Markets⁸ to issue Advisory 87-2, which stated that only funds under the control of the CTA ("Actual Funds") could be included in beginning net asset value ("BNAV").⁹ Advisory 87-2 stated that "funds which the client has promised orally to provide upon request" (there described as "notional" funds) could not be included in BNAV.

After Advisory 87-2 was issued, Commission staff were frequently apprised by industry participants of their concerns regarding the possible distortions to rates of return calculated based on actual funds rather than the account size, designated by the client, upon which the CTA made its trading decisions.¹⁰ In 1993, the Commission issued Advisory 93-13, in an effort to alleviate these concerns and to reach a compromise between the actual funds and the "notional" funds methods of computing performance.¹¹

Advisory 93-13 permitted CTAs to disclose, as their past performance, the

⁶ Commission Rule 4.35(a)(6)(i)(D) currently specifies that net performance represents the change in the net asset value net of additions, withdrawals, redemptions, fees and expenses. Commission Rule 4.10(b) currently defines "net asset value" as "total assets minus total liabilities, determined in accord with generally accepted accounting principles, with each position in a commodity interest accounted for at fair market value."

⁷ Commission Rule 4.35(a)(6)(i)(A).

⁸ Following the Commission's reorganization in July 2001, the Division of Trading and Markets' role with respect to CPOs and CTAs is now carried out by the Division of Clearing and Intermediary Oversight.

⁹ CFTC Advisory 87-2 [1986-87 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 23,624 (June 2, 1987). Advisory 87-2 specified that funds contained in a commodity trading account over which the CTA has been given trading authority must be included in BNAV, and set forth the conditions under which funds contained in any other type of account carried with the FCM could be included in BNAV.

¹⁰ These concerns were among the issues addressed by the Managed Futures Subcommittee of the Commission's Regulatory Coordination Advisory Committee, which existed from 1990 to 1995.

¹¹ CFTC Advisory 93-13, 58 FR 8226 (February 12, 1993). The term "nominal account size" was introduced in Advisory 93-13.

¹ Commission rules cited herein are found at 17 CFR Ch. I (2002).

² Commission Rule 1.33 sets forth the requirements applicable to futures commission merchants ("FCMs") with respect to reporting to their customers. Commission rules cited herein are found at 17 CFR Ch. I (2002).

³ See 64 FR 41843 (August 2, 1999).

⁴ Those proposed amendments developed out of rules proposed by National Futures Association ("NFA") to permit CTAs to disclose past performance as computed on the basis of the client's nominal account size (the amount upon which the CTA bases its trading), rather than on the basis of the actual funds the client has placed in accounts subject to the CTA's control. The NFA proposal was also the subject of a concept release published by the Commission in June 1998 that discussed a number of possible enhancements and alternatives to the NFA proposal and sought public comment on those issues. See 63 FR 33297 (June 18, 1998).

⁵ See 46 FR 26005, 26009 (May 8, 1981). Pursuant to the original Part 4 disclosure rules adopted in 1979, CTAs were permitted, but not required, to disclose their past performance in accordance with the format specified for commodity pool performance. 44 FR 1918, 1923 (January 8, 1979).