

rate of return of a “fully-funded subset” of their accounts, provided that two standards were met.<sup>12</sup> The first standard required that the aggregate of the actual funds for the fully-funded accounts be at least ten percent of the aggregate of the nominal account sizes of the accounts included in the program. The second standard required that the gross trading profit ratio for the subset be “materially the same” as the gross trading profit ratio for the aggregate.<sup>13</sup> In other words, the performance of the subset had to be, in fact, representative of the performance of the aggregate, considered on the basis of the nominal account sizes.

For example, if the CTA had 15 accounts, three of which were fully funded, the CTA could treat the rate of return of the three fully-funded accounts as representative of all 15 accounts as long as the two tests were met. Thus, if all 15 accounts had nominal account sizes of \$100,000, the first standard would be met by the three fully-funded accounts—*i.e.*, \$300,000/\$1,500,000 is twenty percent, which exceeds the ten percent minimum. This test could also be met by one sufficiently large fully-funded account. If each of the 15 accounts experienced gross profits of \$10,000, the gross trading profits ratio of the subset would be the same as the gross trading profits ratio of the aggregate, meeting the second test. Advisory 93–13 explicitly permitted a number of adjustments and exceptions to these two standards. For example, an account could use the fully-funded subset method despite failures to meet the ten percent test “for a limited number of periods.”

Advisory 93–13 ameliorated disclosure problems for those CTAs that had sufficiently fully-funded accounts to meet the ten percent test. Commission staff nonetheless have increasingly encountered circumstances where CTAs have lacked (or lost) sufficient fully-funded accounts, but where disclosure based on actual funds levels would be misleading or confusing.

## 2. Proposed Changes to Commission Regulation 4.35(a)(6)(i) To Adopt Nominal Account Size as the Denominator in the Rate of Return Calculation

Existing Commission Regulation 4.35(a)(6)(i) requires that, in presenting past performance to prospective participants, the rate of return for a period be calculated by dividing net performance by the beginning net asset value. The proposed amendment to Regulation 4.35(a)(6)(i) would require that the rate of return be computed by dividing net performance by the nominal account size at the beginning of the period.<sup>14</sup> It is the proposed change in the denominator of the rate of return computation—from net asset value to nominal account size—that underlies the framework for performance presentation set forth in the rule proposal.

The Commission recognizes that each of the methods that has been used or proposed—the actual funds method, the fully-funded subset method, and the nominal account size method—has flaws. For example, under the actual funds method, two accounts with the same nominal account size, which hold the same market positions and number of contracts, and which experience the same gains or losses, would show different performance if the clients choose to fund their accounts differently.<sup>15</sup> Further, the CTA’s presentation of its past performance for accounts in the same trading program could combine, in the same actual funds-based performance table, accounts with vastly different amounts of actual funds in relation to their nominal size.<sup>16</sup> The resulting composite presentation would blend the results of

these accounts into a rate of return that would not be representative of any client’s actual results. Some might argue that if the actual funds-based returns of these varying funded accounts differed materially from each other, their performance should be presented in separate tables.<sup>17</sup> This could result in numerous performance tables for each of the CTA’s programs, overwhelming clients with excessive amounts of data and severely impeding the usefulness of the performance disclosure.

The fully-funded subset method has turned out to be unworkable for a number of reasons. The primary reason is that many CTAs lack fully-funded accounts. Although Advisory 93–13 allows for limited periods during which the fully-funded subset requirement is not met, this allowance is predicated on the anticipated resumption of the fully-funded subset in the near future. The Division has received numerous questions over the years from CTAs who have qualified for the fully-funded subset method for a period of time, but due to the closing of fully-funded accounts and inability to obtain new fully-funded accounts, cannot continue to use the fully-funded subset method.

Further, in recent years, the use of “master accounts” by commodity pools and clients who allocate to multiple CTAs has greatly increased. A master account is a central account in which a client deposits funds with the FCM to support trading done by several CTAs. Each of the CTAs is given trading authority for a sub-account, which will reflect the positions implemented by that CTA, and profits and losses on these positions, but to which no funds will be deposited. The margin requirements for these positions will be met by funds maintained in the master account. Although the CTA will know the nominal account size, the actual funds reported to the CTA will include only the value of the positions held in the sub-account (which could, in fact, be a negative amount due to unrealized losses). While in the past staff have permitted the allocation of funds in a master account to various CTAs to be computed and reported pursuant to a Liquid Asset Allocation (“LAA”) method,<sup>18</sup> LAA methods have not proven to be workable for the majority of CPOs and other clients with master accounts. Further, it is unclear that such

<sup>12</sup> “Fully-funded” refers to an account where the amount of Actual Funds equals the nominal account size.

<sup>13</sup> Advisory 93–13 included a specific definition of “materially the same” in the context of comparing two percentages, depending on the individual size of the two percentages (*i.e.*, 5 percent or less, between 5 percent and 10 percent, or 10 percent or more) and the difference between the two percentages. See 58 FR at 8229.

<sup>14</sup> Additional changes to Rule 4.35(a)(6)(i)(A)–(F) have been proposed to accommodate the use of nominal account size. These changes will be discussed further below.

<sup>15</sup> For example, Client A and Client B each have a nominal account size of \$100,000. The CTA treats the two accounts identically, trading two S&P 500 futures contracts for each account. Each account experiences a \$10,000 profit. Client A deposits \$25,000 in actual funds, while Client B fully funds the account with \$100,000. Using the actual funds method, Client A’s rate of return would be 40%, and Client B’s rate of return would be 10%, even though each client has the same nominal account size, has been traded identically, and has received the same dollar amount in profits.

<sup>16</sup> In practice, prior to the issuance of Advisory 93–13, Division of Trading and Markets staff interpreted the actual funds method to require one composite table that was based solely on actual funds, and to permit a supplemental table including “notional funds” (57 FR 53457, 53459 (November 10, 1992)). This interpretation appears to have been based on provisions regarding retroactive application of Advisory 87–2, as described in an Addendum to CFTC Advisory 87–2 ([1986–87 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 23,759 (August 12, 1987)).

<sup>17</sup> Rule 4.35(a)(3)(ii) specifies that accounts whose rates of return differ materially from each other may not be presented in the same composite.

<sup>18</sup> See CFTC Interpretative Letter 88–1, “Application of Division of Trading and Markets Advisory 87–2,” [1987–1990 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 24058 at 34639–40 (December 16, 1987).