

allocation provides insight into the return based on "actual" funds.

3. Objections to the Nominal Account Size Method Addressed

Concerns have been raised that CTAs might manipulate their nominal account sizes.¹⁹ A CTA that can establish nominal account sizes without being required to find customers willing to fully fund accounts at such sizes might be unrestrained in setting the nominal account size, and thus could minimize the apparent size of losses and smooth the apparent volatility of its trading over time. Increasing the nominal account size to minimize the apparent size of losses, however, will unavoidably have the effect of minimizing the apparent size of gains. CTAs will thus be faced with countervailing incentives. Some have noted a converse problem posed by the existing rules: futures and derivatives positions can be taken by depositing very small amounts of actual funds for margin, relative to the value of the contract. Positive rates of return computed on the basis of a relatively small amount of actual funds in accounts whose level of trading is based on a much greater nominal account size would be magnified and could provide a potentially misleading measure of the CTA's success. As NFA's comment letter on the earlier rule amendment proposal observed, in its experience, "unwary customers are more likely to be lured into the futures markets by allusions to large profits than by information implying that futures trading is a conservative investment." The Commission's own experience in this area has been similar, and it has no basis to believe that this proposal creates any additional incentives for CTAs to set unreasonable nominal account sizes.

Some have stated that using nominal account size to compute rates of return would create an appearance of lowered volatility and that disclosure of volatility experienced by program participants would be undermined if nominal account size were used to compute rates of return. But the rules proposed in this release are no more likely to mask volatility than the fully-funded subset method permitted since 1993. The funding level—full or partial—chosen by past participants neither helps nor harms prospective participants who will be receiving past performance data based on nominal account size. A prospective participant

who chooses to partially fund will experience volatility magnified by his or her partial funding level, and will not be helped by the fact that other participants chose to fully fund in the past. Conversely, a prospective participant who chooses to fully fund will experience volatility corresponding to the nominal account size, and will not be harmed by the fact that other participants chose to partially fund in the past. Moreover, the performance table will contain a pointed numerical example of the effect of partial funding on volatility in the context of worst monthly and peak-to-valley draw-downs. This example—based either on the lowest actual funding level or a straight 20% funding level—will demonstrate the enhanced volatility of partially funded accounts in a form calculated to draw the participant's attention.

Investors should consider not only the "cash they must put up" initially, but the losses to which they are exposed. In this context, participation in managed futures accounts is far different from investment in stocks, real estate, or even commodity pools. As has been noted: "Commodity trading intrinsically involves leverage, the only purchase is a futures contract (not the actual asset) and the amount of cash required is artificially determined by exchange rules, broker policies, CTA negotiated agreements and regulatory requirements and can change day by day."²⁰

Investments in stock, real estate, or collective investment vehicles such as mutual funds or commodity pools can be quantified in advance, even if purchased on margin or through other borrowing. An investor can purchase 100 shares of Example Co., Inc. (or Example Fund, Inc.) at \$50 a share for \$5,000. Even if these shares are purchased on margin, \$5,000 is generally the limit of the loss to which the investor is exposed.²¹ This relative certainty is absent in the context of futures. A managed futures account participant who enters into, for example, a stock index futures contract gains (or loses) the change in value of the collection of stocks. The participant must post margin, but the margin does not represent the limit of the participant's liability. If the participant's losses exceed the initial margin, the participant will owe the excess. Commission Rule 4.34(b) requires that CTAs disclose these facts to prospective clients, and a CTA which encouraged

participants to think of the "cash they have put up" as the limit of their losses could run afoul of Section 4o of the Commodity Exchange Act (the "Act").²²

To be sure, the Commission has observed that there is no standard among CTAs for the setting of nominal account sizes.²³ The Commission does not intend to impose a standard for the setting of nominal account sizes on CTAs. The proposed rule does require that the CTA disclose the factors it considers in determining the level of trading for a given nominal account size in the offered trading program and an explanation of how those factors are applied. Moreover, adopting nominal account size as the denominator for the rate of return calculation would provide a uniform basis for all CTAs to present rate of return, which does not exist under the reporting scheme that has been in effect since the adoption of Advisory 93-13. Use of nominal account size would permit a much more meaningful comparison of the performance results of CTAs.

After consideration of the benefits and drawbacks of each of these methods of calculating CTAs' rates of return, the Commission is proposing the nominal account size method, coupled with a framework of documentation and disclosure requirements, as the method that best reflects the reality of how managed accounts are traded, including information regarding volatility and draw-downs. As discussed more fully below, the existence of a written agreement that documents the nominal account size in advance of the CTA's trading for the account is a critical component of the performance calculation and reporting scheme the Commission is proposing.

B. Documentation of Nominal Account Size

The proposed rules would add new paragraph (c) to Rule 4.33 to require documentation of the nominal account size agreed upon by the CTA and client, as well as other terms applicable to the CTA's trading for the client's account. This provision would require that the CTA execute a written agreement with each client that specifies: The nominal account size; the name or description of the trading program in which the client is participating; the basis for the computation of fees; how additions or withdrawals of actual funds, or profits and losses will affect each of (a) the nominal account size and (b) the computation of fees; and whether the client will fully or partially fund the

¹⁹ See, e.g., "Proposed Rule Could Help Mask Commodity Trading Volatility," New York Times, September 2, 1999; and "Commodity-Adviser Reporting Rule May Change," Wall Street Journal, September 7, 1999.

²⁰ Arthur F. Bell, Jr. & Associates commenting on the earlier rule amendment proposal.

²¹ Transaction fees and interest are being ignored for the purposes of these examples.

²² 7 U.S.C. 6o (2000).

²³ See 63 FR 33297 (June 18, 1998).