

account. The requirement that the nominal account size must be documented in advance of the CTA's trading for the client's account will also minimize the possibility that CTAs will manipulate their returns to appear either less volatile or more positive by frequent adjustment of their nominal account sizes, particularly since any revision to the nominal account size must be documented in a new agreement, or an addendum to the existing agreement, signed by the client.

The Commission believes that documentation of the agreement between CTAs and their clients is important, even if all the CTA's client accounts are fully-funded, and therefore the proposed requirements of Rule 4.33(c) would apply to CTAs whether or not they accept partially funded accounts. As the proposed rule indicates, CTAs would not need to use a separate agreement to respond to the requirements specified in Rule 4.33(c), but could incorporate the requirements into their existing client agreements.

In addition, Rule 4.33(c) would require that changes to nominal account size, other than those explicitly provided for in the existing agreement (e.g., the effect of gains/losses), must be in writing, must be signed by the client, and must explicitly indicate the current date, the change in the nominal account size and the effective date of that change.<sup>24</sup> This requirement could be met by a simple one-sentence note from the client requesting the change in nominal account size and including the dollar amount of the new nominal account size, the effective date of the change, the signature and typed or printed name of the client, and the date the request was signed.<sup>25</sup>

### C. Changes to Definitions

The Commission proposed revisions to Rule 4.10(l) to accommodate use of nominal account size as the denominator in the calculation of the peak-to-valley draw-down figures.<sup>26</sup>

<sup>24</sup> The effective date would be on or after the date that the change is made.

<sup>25</sup> Commission Rule 1.4 permits use of electronic signatures with respect to compliance with Commission rules that require a document to be signed by a customer, participant or client. An electronic signature could therefore be used for the agreement required by Rule 4.33(c), in accordance with the provisions of Rule 1.4 (i.e., that the electronic signature complies with applicable Federal laws and other Commission rules, and that the CTA must adopt and utilize reasonable safeguards regarding the use of electronic signatures).

<sup>26</sup> Rule 4.10(k) defines "draw-down" as "losses experienced by a pool or account over a specified period." Since the definition in Rule 4.10(k) does not refer to a method for computing such losses, no revision to this definition would be necessary.

Additional changes are being proposed to codify definitions of nominal account size (Rule 4.10(m)), actual funds (Rule 4.10(n)), partially-funded account (Rule 4.10(o)) and most recent five years (4.10(p)).

The Commission wishes to make clear that Advisories 87–2 and 93–13, as well as Interpretative Letter 88–1, would be, on a prospective basis, superseded in their entirety by the proposed rules or any final rules resulting from this rulemaking. Questions have been raised about the continuing applicability of the quantitative materiality standard that was established in Advisory 93–13 to determine whether a CTA's accounts qualified for use of the fully-funded subset method. Although Advisory 93–13 clearly stated that the standard was intended to be applicable only in the context of the Advisory, the Commission understands that these standards have come to be relied on more broadly in ascertaining compliance with composite performance requirements of Rule 4.35(a)(3). The Commission would accept those standards as guidance, but not to the exclusion of other approaches that may fall outside the threshold of Advisory 93–13. Registrants should continue to consider all relevant facts and circumstances in making determinations regarding materiality.

### D. Disclosure of Actual Funding Levels and Funds Under Management

The Commission believes that it would be misleading to describe "notional funds," which the client has chosen not to place in an account over which the CTA has trading authority, as "funds under management." The proposed revisions to Rule 4.35(a)(1)(iv), therefore, would clarify that the disclosure of funds under management must reflect only the actual funds committed to the CTA's trading program rather than the aggregate of nominal account sizes.

The Commission's proposed adoption of nominal account size for purposes of computing the CTA's trading program rate of return is not intended to eliminate the distinction between actual funds and nominal account size. As we have noted before, nominal account size is not a commitment of actual funds to the CTA's control, nor does it represent the maximum amount of the client's potential losses or of the client's obligations to the FCM. The Commission continues to believe that knowledge of the amount of funds that a CTA's clients have been willing to entrust to the control of the CTA, or the fact that the CTA does not possess such information, may be considered

valuable by prospective clients. In addition, CTAs would not be precluded from disclosing the aggregate of nominal account sizes, and in fact may choose to present such information in their performance capsules adjacent to the disclosure of actual funds under management (See proposed Rule 4.35(a)(1)(ix)(D)). Therefore, the Commission is proposing revisions to Rule 4.35(a)(1)(iv).

To accommodate those situations where CTAs do not have access to information regarding clients' actual funds, proposed Rule 4.35(a)(1)(iv) would permit a CTA simply to make a statement of the fact that it does not have sufficient information regarding the funding of its clients' accounts to determine the aggregate of actual funds committed to its programs. Cases involving the use of master accounts, or other funding arrangements between the client and FCM, that preclude the CTA from having access to information regarding the client's actual funds, might lead CTAs to state that they do not know the amount of actual funds. The representation by the CTA of its lack of knowledge of this amount will provide clients with valuable information regarding the extent to which they may rely on that factor. The CTA would continue to be required to maintain the documentation on which its performance presentation is based<sup>27</sup> and such documentation should be sufficient to support the information in the performance capsule regarding the disclosure, if any, of actual funds under management.

### E. Disclosures Regarding Partial Funding of Accounts

Proposed Rule 4.34(p) would require disclosure to prospective clients of material information concerning the practice of partially funding an account and the factors considered by the CTA in determining the trading level for a given nominal account size. The discussion would be required to include: (1) How the management fees would be computed, expressed as a percentage of the nominal account size, and an explanation of the effect of partially funding an account on the management fees as a percentage of actual funds; (2) an estimated range of the commissions generally charged to an account expressed as a percentage of the nominal account size and an explanation of the effect of partially funding an account on the commissions as a percentage of actual funds; (3) a statement that partial funding increases leverage, that leverage will magnify both

<sup>27</sup> See Rules 4.33(a) and 4.35(a)(6)(iii).