

positive and negative rates of return, and that the greater the disparity between the nominal account size and the amount deposited, maintained or made accessible to the FCM, the greater the likelihood and frequency of margin calls, and the greater the size of margin calls as a percentage of the amount of actual funds committed to the commodity trading advisor's program; and (4) a description of the factors considered by the CTA 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.

F. Disclosures Concerning Draw-down

1. Disclosure of Draw-Down at the Lowest Funding Level

Proposed Rule 4.35(a)(1)(ix)(A) would require CTAs who accept partially-funded accounts to present draw-down figures computed on the basis of the actual funds committed to the CTA's program by the client with the lowest ratio of actual funds to nominal account size in the trading program.²⁸ If the CTA did not have sufficient information regarding the funding level of its client accounts, or if the lowest ratio was zero, the draw-down information would be presented at a funding level of 20 percent. These additional draw-down figures would be presented adjacent to the worst monthly and peak-to-valley draw-down percentages based on the aggregate nominal account sizes.

If a client funds its account traded by the CTA at a level of actual funds that is less than the nominal account size, then gains or losses will represent a larger percentage of the client's actual funds. Further, the smaller the amount of actual funds is in relation to the nominal account size, the faster losses will reduce the amount of actual funds, increasing both the likelihood of margin calls and the amount of additional margin that may be required. The purpose of disclosing draw-downs at the least-funded level is to highlight these effects to prospective clients who may be considering partially funding their accounts with the CTA. The option of using a 20% level is intended to accommodate situations where the CTA does not have sufficient information regarding the funding level of its client accounts, or where the lowest funding ratio is zero, precluding calculation of a meaningful number.

²⁸ For example, if the lowest funding level is 25 percent and the greatest monthly draw-down is 15 percent, the draw-down shown on the basis of actual funding would be 60 percent (15 percent ÷ 25 percent).

Proposed Rule 4.35(a)(1)(ix)(A) would require the addition of only two percentage draw-down figures, adjacent to the worst monthly and peak-to-valley draw-down percentages for the aggregate nominal account sizes. This would not amount to data overload. Further, since the intent of the disclosure is to convey the impact of draw-downs on the actual funds in partially-funded accounts, use of the 20% funding level where CTAs do not have any accounts with actual funding or do not know the amount of actual funds would enable their performance capsules to convey information about the increased impact of draw-downs on the actual funds in partially-funded accounts.

2. Use of Composite Draw-down

Proposed Rules 4.35(a)(1)(v) and (vi) would require that the worst monthly and peak-to-valley draw-down amounts be based on the aggregate of nominal account sizes, *i.e.*, the composite of accounts, rather than the worst individual account.²⁹ A variety of factors, including, but not limited to, differences due to trade execution, fees, commissions, and the timing of opening or closing accounts, may have an impact on the returns for individual accounts. The effect of these factors must be considered by the CTA in the development of its composite performance tables and any material differences among the accounts in the composite must be discussed.³⁰ For a performance table that complies with the Commission's rules on use of composites, disclosure of draw-down information on a composite basis would not be misleading. However, CTAs would remain subject to the requirement of Rule 4.34(o) to disclose all material information to existing or prospective clients even if such

²⁹ Current Rule 4.10(k) defines the term "Draw-down" as "losses experienced by a pool or account over a specified period: Rule 4.10(l) defines the term "Worst peak-to-valley draw-down" for a pool, account or trading program. In its adopting release for the most recent revisions to the Part 4 rules, the Commission noted that "... the draw-down figures in a composite in a CTA Disclosure Documents are the worst experienced by any one of the accounts included in the composite" (emphasis added). 60 FR 38146, 38162 (July 25, 1995).

³⁰ Rule 4.35(a)(3) states:

(i) Unless such presentation would be misleading, the performance of accounts traded pursuant to the same trading program may be presented in composite form on a program-by-program basis * * *.

(ii) Accounts that differ materially with respect to rate of return may not be presented in the same composite.

(iii) The commodity trading advisor must discuss all material differences among the accounts included in a composite.

information is not specifically required by these regulations.

G. Treatment of Interest Income

The proposed definition of net performance in Rules 4.10(l)(3) and 4.35(a)(6)(i)(B)³¹ would permit CTAs to include interest income on funds deposited in the client's commodity interest account directed by the CTA, as well as any other income on positions held as part of the CTA's program. The fact that trading fees are charged against the CTA's performance, even where the commission rate is negotiated by the client and the FCM, supports the inclusion of interest earned at the FCM in the CTA's performance to maintain parity. In addition, interest is, in a real sense, part of the return on the funds. Regardless of the amount of actual funds a client deposits with the FCM, whether influenced by the CTA's trading strategies, the FCM's credit determination, or the client's wishes, income on these funds is part of the account's performance. Further, the computation of net performance under the regulations that have been in effect since 1981 has included interest income. The components of net performance—the numerator of the rate of return computation—will not be affected by the change of the denominator from net asset value to nominal account size. It is the adoption of nominal account size, rather than net asset value, as the basis for performance calculation that will require changes to the definition of net performance in proposed Rules 4.10(l)(3) and 4.35(a)(6)(i)(B).

The proposed rule also would provide that no interest income may be imputed with respect to nominal account sizes or otherwise computed on a pro-forma basis. The Commission notes that the reference in the proposed rules to "other income" on instruments held as part of the CTA's program is intended to apply to programs in which the CTA may direct the trading of instruments, such as stocks or bonds, on which income is earned.³² While this provision may not be applicable to most CTAs, it is intended to permit those CTAs who direct the trading of income-producing

³¹ Although net performance is defined in the context of both Rule 4.10(l), with respect to computation of worst peak-to-valley draw-down, and Rule 4.35(a)(6)(i)(B), with respect to calculation of performance information, the definitions are the same.

³² While this provision acknowledges that CTAs may offer programs that trade instruments in addition to futures contracts, it in no way implies that such activity may be conducted by CTAs outside of the appropriate registration or other regulatory requirements of agencies with jurisdiction over those instruments.