

II. Final Rules

A. Use of Nominal Account Size and Other Detailed Performance Requirements in the Proposal

The key component of the Commission's rule proposal is the use of nominal account size, rather than actual funds, as the basis for CTAs' computation of rates of return. The consumer organization and members of the public noted that investors look at actual funds when making investment decisions, and expressed concern that performance based on nominal account size would reduce the appearance of volatility of the CTA's trading program. Commenters who supported use of nominal account size noted that it is the amount both the CTA and the client consider to be the account size. They also pointed out that use of actual funds can result in widely divergent return figures for similarly traded accounts; exaggerates positive and negative rates of return; and measures the cash management strategies of clients rather than the performance of the CTA.

The Commission has not found persuasive the comments opposing use of nominal account size rather than actual funds as the basis for computing CTA rates of return. Some commenters and press reports appear to have misunderstood the intent of past performance reporting under Commission rules—to present to prospective clients information on how the trading program, which the CTA is offering, has performed. The amount of actual funds in a client's account is determined by the client and its FCM, not the CTA, and does not affect the CTA's trading decisions based on nominal account size. Use of nominal account size would permit CTAs to present to prospective clients composite performance results that will be consistent for the accounts within the program, even if those accounts have widely divergent amounts of actual funds supporting the same level of trading. The alternatives—either blending all accounts, regardless of the variation in funding levels, into a single actual funds-based table, or presenting multiple performance tables to address each individual funding level—could be less informative and potentially more confusing to prospective clients.

The Commission similarly does not agree that disclosure of the volatility and risk of a CTA's trading program will be reduced if the nominal account size is used. As NFA noted in its comment letter, the proposed use of nominal account size would not understate either volatility or risk, as the dollar amount of any profit or loss will be the

same for accounts with the same nominal account size, regardless of the funding level. Further, whatever incentive a CTA may have to make its losses appear smaller would be offset by the fact that calculating rate of return on a larger nominal account size would reduce the appearance of profits as well.

B. Adoption of a Core Principle

In seeking comment on the desirability of implementing a core principle in the proposing release, the Commission cited Congressional intent as expressed in the Commodity Futures Modernization Act of 2000 ("CFMA").⁸ Section 125 of the CFMA required the Commission to conduct a study of the Act and the Commission's rules and orders governing the conduct of registrants under the Act, identifying, among other things, Commission rules that could be replaced with core principles.⁹ While commenters participating in the study expressed concerns regarding replacement of regulations with core principles in certain contexts, they did identify a number of areas where existing rules could be modified or eliminated.¹⁰ Several commenters on the current proposal noted that the flexibility offered by a core principle might not adequately address the need for a standard method of calculating performance that will enable continuity and comparability in the presentation of CTAs' rates of return. The Commission believes, however, that a core principle adopted by the Commission would not preclude the development of more explicit guidance or performance standards by the Commission, self-regulatory organizations, and/or an independent organization, as one commenter suggested, that is otherwise consistent with the core principle.¹¹ The

⁸ Pub. L. 106-554, 114 Stat. 2763 (2000) (codified as amended in scattered sections of 7 U.S.C.).

⁹ A copy of the study may be viewed on the Commission's Web site at: www.cftc.gov/files/opa/opaintermediarystudy.pdf.

¹⁰ Report on the Study of the Commodity Exchange Act and the Commission's Rules and Orders Governing the Conduct of Registrants Under the Act, p. 25. In certain areas, commenters mentioned concerns with regard to the practicability and legal certainty of core principles.

¹¹ For example, the Association for Investment Management Research ("AIMR"), an international nonprofit organization of investment practitioners and educators, has developed voluntary standards for presentation of investment performance that are used by many investment managers and advisers. AIMR's Investment Performance Council recently issued an invitation to comment on proposed guidance regarding leverage and derivatives to be added to its Global Investment Performance Standards (GIPS). Neither the existing GIPS standards nor the proposed guidance directly addresses the partial funding issue that is the subject of the core principle adopted herein. As

Commission understands that NFA plans in the near future to adopt specific rules regarding presentation of partially funded accounts that would apply to all member CTAs,¹² and that would be consistent with the rules proposed by the Commission.¹³ Although the Commission agrees that nominal account size is an appropriate basis for calculating performance results, the Commission encourages NFA, in the development of guidance carrying out a core principle approach, to consider whether or not these nominal account performance results can be supplemented with other performance measures or statistics that enable customers with accounts that are not fully funded to generally gauge performance results for these types of accounts. The Commission further notes that CTAs presenting partially funded account performance in accordance with the detailed requirements in its March 2003 rule proposal¹⁴ will be considered to be in compliance with the core principle.

After evaluating the comments received on both the detailed proposed amendments and the alternative of a core principle described in the proposal, the Commission has determined not to adopt the detailed proposed rules, but rather to amend Commission Rule 4.35(a)¹⁵ so as to permit CTAs to comply with a core principle with respect to the performance of partially-funded accounts. While the Commission is fully supportive of the content and approach of its detailed rule proposal of March 2003, the history of discourse on this issue suggests that any prescriptive rule adopted by the Commission could soon be inconsistent with evolving industry developments and practices in this area. The flexibility of a core principle, rather than a single set of rigid requirements, would ensure that core Commission regulatory concerns are complied with without impeding legitimate business needs. The Commission believes that this approach is consistent with the objective of the CFMA that the Commission, when

standards such as AIMR's evolve to address this issue, they may provide additional guidance to persons or organizations seeking to comply with this core principle or seeking to develop best practices in this area.

¹² With exceptions not otherwise pertinent here, a CTA that conducts futures business with the public and is required to register with the Commission must be a member of NFA, pursuant to NFA Bylaw 1101.

¹³ Any rules adopted by NFA would be submitted to the Commission according to the review process for rules of a registered futures association provided in Section 17(j) of the Act.

¹⁴ See note 1.

¹⁵ Commission rules referred to herein may be found at 17 CFR Ch. I (2002).