

time period even if they were opened more than five years earlier, may result in a reduction in useful information. As it noted in the Performance Proposal, the Commission does not believe that this change will diminish the disclosure of material information to prospective clients, because of the tendency of clients to quickly close accounts that experience large losses. Accounts that experienced strongly negative returns before the five-year time period are likely to have been closed before the end of that time period, and losses experienced as a result of the offered program during the five-year period are likely to have been experienced by an account that both opened and closed during that period. The Commission wishes to make clear that any additional information that the CTA believes is necessary to explain the circumstances affecting the measure of the variability of returns presented in the performance capsule may be provided, pursuant to existing rules regarding supplemental disclosures and material information.⁶⁰

B. Use of Composite Draw-Down

Although the Commission is not adopting the proposed revision to Rules 4.35(a)(1)(v) and (vi) which would have required that the worst monthly and peak-to-valley draw-down amounts be based on the aggregate of nominal account sizes, based on the comments received, the Commission believes it is necessary to clarify the issue of presenting draw-down information on the composite of accounts, rather than on the worst individual account.

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 the 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).⁶¹ Several commenters expressed concern that composite draw-down would not provide sufficient information as to how bad things might have been for individual accounts. However, other commenters noted that performance of a single account may be misleading due to factors beyond the CTA's control, such as the client's determination of when to open or close the account. Another commenter stated that the purpose of draw-down

disclosure in performance capsules is to highlight the historical risk and volatility of a particular trading program, not the general risk of futures trading, which is adequately addressed by other rules.

As noted in the Performance Proposal, 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.⁶² The Commission continues to believe that 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. The Commission therefore confirms that presentation of monthly and peak-to-valley draw-down information on a composite basis for performance tables that comply with Rule 4.35(a)(3) will be acceptable. CTAs remain subject to the requirement of Rule 4.34(o) to disclose all material information to existing or prospective clients even if such information is not specifically required by these regulations.

C. Treatment of Additions and Withdrawals in Computing Rate of Return

The changes to the rate of return computation in the Performance Proposal would have codified, in a streamlined fashion, several methods of accounting for additions and withdrawals in computing rate of return that were permitted by the Commission's 1991 Advisory.⁶³ In addition to the method currently required by Rule 4.35(a)(6)(i)(F), these methods would include daily compounding and time-weighting of

additions and withdrawals. However, the Only Accounts Traded Method, which had been permitted by the 1991 Advisory, was not included as an option CTAs could choose prospectively due to concerns that it allows for accounts to be excluded entirely from the rate of return calculation. One commenter noted that CTAs can reach the same result as the proposed daily compounded rate of return when the calculation is compounded based on each sub-period in which an addition or withdrawal is made. Two commenters requested that CTAs continue to be permitted to exclude from the return calculation accounts that opened or closed intramonth, to avoid material distortions that can occur. Although the Commission adopted a core principle for partially funded account performance and therefore did not implement the proposed changes to the rate of return calculation, based on the comments received on the Performance Proposal, the Commission believes it is appropriate to provide guidance regarding the treatment of additions and withdrawals in computing rate of return.

D. New Appendix B to Part 4

New appendix B to part 4 provides guidance concerning alternate methods by which CPOs and CTAs may calculate the rate of return information required by Rules 4.25(a)(7)(i)(F) and 4.35(a)(6)(i)(F). Performance computed in accordance with any of the alternative methods described in the 1991 Advisory for periods prior to the effective date of these rule changes would not need to be revised. However, the 1991 Advisory is superseded prospectively by Appendix B adopted herein.

IV. Related Matters

A. Regulatory Flexibility Act

The Regulatory Flexibility Act (RFA)⁶⁴ requires that agencies, in proposing rules, consider the impact of those rules on small businesses. The Commission has previously established certain definitions of "small entities" to be used by the Commission in evaluating the impact of its rules on such entities in accordance with the RFA.⁶⁵ With respect to CPOs, the Commission has previously determined that a CPO is a small entity if it meets the criteria for exemption from registration under current Rule 4.13(a)(2).⁶⁶ Therefore, the requirements

⁶² 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.

⁶³ "Adjustments for Additions and Withdrawals to Computation of Rate of Return in Performance Records of Commodity Pool Operators and Commodity Trading Advisors," 56 FR 8109 (Feb. 27, 1991). Rule 4.35(a)(6) states that performance information may be calculated as specified therein "or by a method otherwise approved by the Commission."

⁶⁰ See Rules 4.34(n) and 4.34(o).

⁶¹ 60 FR 38146, 38163 (July 25, 1995).

⁶⁴ 5 U.S.C. 601 *et seq.*

⁶⁵ 47 FR 18618 (April 30, 1982).

⁶⁶ *Id.* at 18619–20.