NATIONAL FUTURES ASSOCIATION
200 W. MADISON ST. • CHICAGO, IL • 60606-3447 • (312) 781-1300

March 15, 1994

Ms. Jean A. Webb
Secretariat
Commodity Futures Trading Commission
2033 K Street, N.W.
Washington, D.C. 20581

Re: National Futures Association: Proposed Amendments to NFA Compliance Rules 2-13 and 2-29, Adoption of NFA Compliance Rule 2-34, and Interpretive Notices to NFA Compliance Rule 2-13

Dear Ms. Webb:

Pursuant to Section 17(j) of the Commodity Exchange Act, as amended, National Futures Association ("NFA") hereby submits to the Commodity Futures Trading Commission ("Commission") proposed amendments to NFA Compliance Rules 2-13 and 2-29, adoption of NFA Compliance Rule 2-34 and Interpretive Notices to NFA Compliance Rule 2-13. The proposed rule amendments, new rule and interpretive notices were approved by NFA's Board of Directors ("Board") on February 24, 1994. NFA respectfully requests Commission review and approval of these proposals.

The Special Committee for the Review of CPO/CTA Disclosure Issues

Last May, NFA's Board of Directors appointed the Special Committee for the Review of CPO/CTA Disclosure Issues ("Special Committee") based on its belief that regulatory requirements concerning CPO and CTA disclosure documents had not kept pace with the sweeping changes in the managed funds industry. Specifically, the Board was concerned that as disclosure documents become longer and longer, they provide less and less usable information to customers. The Board directed the Special Committee to develop suggested changes to disclosure document requirements which would produce a more concise, more "user friendly" disclosure document.

To ensure that a broad range of perspectives was represented on the Special Committee the Board not only appointed prominent CPO and CTA Members to the Special Committee but also invited the participation of attorneys and accountants who practice extensively in the futures area. In addition, members of the Commission's staff were invited to attend each of the Special Committee's sessions so that the Commission would be fully informed of the status of the Special Committee's deliberations.

After months of intensive discussions, the Special Committee issued a release to all NFA Members seeking comments on specific recommendations in late December. NFA received comments from 24 CPO or CTA Members of NFA, two IB Members, the FCM, CPO/CTA and IB Advisory Committees, the City Bar Association of New York and the Futures Industry Association. After reviewing those comments, the Special Committee finalized its recommendations and presented them to NFA's Board, which unanimously approved them at its last meeting. In sum, the proposed changes approved by NFA's Board would:

1) replace long and complex performance tables with capsule performance histories for each pool or trading program for which performance must be disclosed;

2) limit past performance information to those pools which are directly relevant to the customer's investment decisions;

3) expand the minimum time period for which performance must be disclosed from three to five years and prohibit "cherry picking" performance periods beyond the five-year minimum;

4) prohibit the inclusion of proprietary trading results in customer performance histories;

5) require CTAs to maintain documentation signed by the customer indicating the amount of funds the CTA is to use as the basis for its trading decisions. That "nominal account size" would then be used as the BNAV for purposes of performance history. If the nominal account size is greater than the amount of funds deposited with the FCM, the CTA must make certain written disclosures to the customers;

6) severely limit the use of hypothetical results;

7) require CPOs to include a tabular break-even analysis in their disclosure documents; and

8) streamline the disclosure of information regarding civil litigation and business background of principals.

I. EXPLANATION OF THE PROPOSED AMENDMENTS

Format for the Presentation of Past Performance Information

All of the members of the Special Committee agreed that the presentation of past performance information in lengthy and complex performance tables does not serve the best interests of either the prospective customer or the CPO or CTA involved. The current disclosure requirements imposed by the CFTC and the SEC are all intended to ensure that the prospective customer is given accurate information regarding the overall past performance of the relevant CPOs or CTAs, their more recent performance and their historical volatility. Unfortunately, what often results is page after page of complex tables which are expensive to produce and incomprehensible to the average prospective customer.

As an alternative to the current requirements the Special Committee would recommend a separate capsule description of the past performance of each pool which is subject to disclosure (or a composite of such pools where appropriate). The capsule description would include the following precise pieces of information which, in the Special Committee's view, would be most important to prospective customers:

1. Name of the fund
2. Description of fund
3. Inception of trading
4. Initial capitalization
5. Current capitalization
6. Compound rate of return
7. Best return for any calendar year
8. Worst return for any calendar year
9. Worst peak to valley
10. Worst monthly drawdown
11. Current year to date return

In the Special Committee's view, this sort of format would be much more "user friendly" than the current table format. The customer would have all of the most important information, including information on the pool's historical volatility, at his fingertips and would not have to wade through lengthy tables trying to find it. At the same time, the capsule format would be far less expensive to prepare and present in a disclosure document.

The Special Committee agreed that the exact format for the presentation of these points of information should be left to the discretion of the CPO. Though the Members would have some flexibility in shaping the exact format of the capsule history, that flexibility could not be used in any way which obscured the required information or was in any way misleading.

It was also agreed that the CPO would be required to maintain supporting documentation for all of the displayed information and would be required to make the documentation available to regulatory authorities upon request. In addition, the displayed information would be computed based upon standardized calculation guidelines.

The Special Committee recommended the same sort of capsule history format for CTA disclosure documents as well. Obviously, there would be minor changes to the specific bullets of information to be listed in the CTA disclosure document. Specifically, while CPOs must show the name and brief description of the fund which is the subject of the capsule, CTAs would show the name and description of the trading program shown in the capsule. The other points of information would be the same. The Special Committee recognized that CTA disclosure documents are not generally as long or as cumbersome as CPO documents and, therefore, the need to provide a more concise format for past performance information may be somewhat less critical. Nevertheless, the Special Committee felt, and the Board agreed, that the capsule format suggested for CPOs would also provide benefits to prospective CTA customers as well. Specifically, the capsule history would provide all prospective customers with immediate access to the most important information which a sophisticated customer could cull from CTA performance tables after an extensive review.

With the exception of one Member, all of the comment letters received on this point and all of the Advisory Committees strongly supported disclosing past performance through capsule histories rather than the current performance tables. Several commenters suggested refinements to the items of information to be included in the capsule presentation proposed by the Special Committee. Various commenters, including FIA, suggested that the items of information be expanded to include additions and withdrawals, annual rates of return or a measure of annual return in relation to volatility.

The Special Committee and the Board carefully considered these suggestions but ultimately decided to retain the capsule format as originally suggested. In their view, information concerning additions and withdrawals adds little meaningful information for prospective customers and the inclusion of the best and worst annual returns, along with the worst peak-to-valley and worst monthly drawdowns, would provide customers with ample information concerning the relative volatility of the pool or trading program.

Whose Past Performance Must be Disclosed

The members of the Special Committee all felt that the presentation of information concerning past performance could also be simplified and clarified by revising the current regulations concerning whose past performance must be disclosed. Under the current regulations CPOs generally must disclose the performance history of the pool being offered, all other pools operated by the CPO or any of its principals and all accounts managed by any of the pool's CTAs or their principals. In many situations most of the past performance data which must be disclosed has little or nothing to do with the product currently being offered by the CPO. In these situations, including all of the required past performance information is both confusing and wasteful.

If, for example, the pool being offered is a multi-advisor fund, the most material past performance information for the customer relates to the CPO's ability to allocate assets among CTAs. The Special Committee therefore recommends that if a CPO offering a multi-advisor fund has been operating such funds for at least three years, the CPO should only be required to disclose separate capsule histories for the past performance of his multi-advisor funds. The Special Committee would recommend that the term "multi-advisor fund" be defined as any pool for which there are three or more CTAs, none of whom control more than 50% of the pool's assets. The Special Committee would anticipate that generally there would be a separate capsule for each multi-advisor pool operated by the CPO.

The question then becomes what performance history, if any, should the CPO of a multi-advisor fund show for its single advisor funds. In fact, this same sort of issue arises any time the CPO's current offering is different in kind than other pools which the CPO has previously operated. Arguably, the performance of the CPO's single advisor funds has little or nothing to do with its ability to allocate assets among several CTAs. Similarly, the performance of a CPO's guaranteed funds may be of little use when the current offering is not guaranteed.

The Special Committee recognized that including past performance of pools which are strikingly different from the fund being offered to customers not only adds clutter to the disclosure document but could actually be misleading. At the same time, the Special Committee was concerned that a CPO with consistently poor performance in one type of fund should not be allowed to hide his performance simply by switching formats. In short, the customer's attention should be focused on the past performance of the CPO's pools which are similar to the current offering but he should also be informed of the past performance of the CPO's other pools as well. The Special Committee therefore recommends that CPOs be required to present a separate capsule history for each pool which is similar to the current offering and composite capsules for all other pools. For purposes of determining whether any two pools are "similar," the Special Committee would recommend the following categories: guaranteed funds, non-guaranteed funds with a single advisor and non-guaranteed funds with more than one advisor.

The Special Committee also discussed at length the disclosure requirements for multi-advisor funds where the CPO has less than three years' experience in operating such funds. The concern was that a CPO with no significant track record in operating multi-advisor funds could sell the fund by "hyping" the recent performance of the CTAs he has initially selected. Some members of the Special Committee would prohibit the CPO in those circumstances from displaying the CTAs' performance history, requiring the CPO to disclose instead the performance of a generally accepted industry index. The majority, however, concluded that not allowing the new CPO to display the past performance of the CTAs he has selected could create a barrier to entry and could deprive the client of relevant information. The Special Committee therefore recommends that CPOs offering multi-advisor funds with less than three years of experience in operating such funds should be allowed to display the performance history of the CTAs but the history must be accompanied by a disclaimer which would plainly state the limitations on the usefulness of that information.

The Special Committee also felt that past performance information should be more limited when the pool itself is an open offering which has traded for more than three years. In this situation the most meaningful information for prospective customers is the past performance of the pool being offered. The Special Committee therefore recommends that where the pool being offered has traded for more than three years, the CPO should only be required to present past performance information for that specific pool.

All of the commenters and all of the Advisory Committees on this point agreed that past performance information which must be disclosed should relate to the product currently being offered to customers and supported the Special Committee's recommendation. Some commenters, however, suggested slight changes to the proposed definition of "multi-advisor pool." The Special Committee and the Board considered these suggestions but determined that the original proposal more accurately reflects industry practice. The City Bar Association of New York noted that there can be substantial differences in trading strategies among pools in the same broad categories suggested by the Special Committee and suggested that more narrow subgroups be considered. The Board recognizes that pools within a particular category may have significant differences in results and strategies but felt that those differences can be and should be adequately explained in the text of the disclosure document.

Time Period Covered for Past Performance Information

There was considerable discussion as to the time period for which past performance would have to be disclosed under this sort of capsule format. Since disclosure for lengthy periods would no longer require confusing and expensive tables, some initially felt that the capsule performance information should cover the life of the CPO or CTA. Others felt that at some point the past trading may bear so little relation to the current trading methods employed by the CPO or CTA that inclusion of the dated information could be misleading. All agreed, however, that for purposes of regulatory certainty, the rules should specify a minimum period which must be disclosed.

The Special Committee suggested that the capsule performance history should cover at least the last five years or the CPO's or CTA's entire history, whichever is less. CPOs or CTAs could choose to cover more than the required five years, provided the additional information was not misleading. For example, a CPO or CTA could not selectively show more than five years but less than his entire history if the additional time period covered was not representative of his overall performance. In addition, the Special Committee suggested that CPOs and CTAs could not include additional time periods in their capsule histories unless those additional periods were covered in their entirety. With one exception, all of the commenters addressing this point agreed with the Special Committee's recommendation. One commenter suggested that CPO and CTA track records should cover their entire history. The Special Committee concluded, however, that since the CFTC's record retention rules only go back five years, it could be unfair to require CPOs and CTAs to create track records beyond that period.

Proprietary Trading Results

The Special Committee also discussed the circumstances in which a CPO's or CTA's proprietary trading results could be included in a capsule composite of customer results. All members of the Special Committee agreed that proprietary trading results should not be included with customer results if their inclusion materially improves the overall performance. Some members felt that where inclusion of the proprietary trading results does not materially alter the overall results, there is no particular harm in including them. The majority of the Special Committee felt that under those circumstances there is also no particular harm to the CPO or CTA in excluding the proprietary results and that for the sake of clarity it would be better to prohibit the inclusion of proprietary results in a customer composite. The Special Committee agreed that the proprietary results could be displayed separately if appropriate disclosures were made for differentials relating to fees and other factors. Commenters on this point agreed with the Special Committee's recommendations.

Nominal Account Size

As the number and sophistication of CTA customers has increased, so has the complexity of their cash management strategies. Many customers may well choose for their own cash management purposes to deposit only the portion of funds required for margin purposes or some amount less than the total allocation with an FCM. Thus, in many instances such customers will instruct a CTA to use a certain dollar figure as the basis for the CTA's trading decisions but will maintain a much lower balance in their trading account at the FCM.

None would contest that this practice is based on legitimate needs and business practices of such clients. The Commission has recognized, however, and NFA agrees, that this legitimate business practice can raise some legitimate regulatory concerns. In NFA's view, regulatory requirements governing the "nominal account size" issue must:

- ensure that all customers clearly understand all of the ramifications of such a practice, including the effect on volatility, margin calls, calculation of fees and overall impact on potential trading risks;

- ensure sufficient documentation exists to prevent a CTA from manipulating his past performance track record by manipulating the amount the CTA shows as the beginning net asset value;

- prevent the sales practice abuses which could occur if such a program was marketed to unsophisticated customers for whom the additional leverage could pose a degree of risk they would be unwilling or unable to accept; and

- ensure that the FCM carrying the account is aware of the additional amount of leverage which the CTA intends to employ in trading the account.

The Commission's response to the issue of notional funding has evolved from its first formal advisory on the topic in 1987 to its most recent pronouncement in February, 1993. In general, the Commission has addressed these concerns by focusing on the issue of how BNAV should be computed in reporting past performance, i.e., whether the amount deposited with the FCM or the larger "nominal" figure should be used in computing rate of return.

The Commission's advisories provide a CTA who has agreed to trade accounts on a notional funding basis with three options:

1) The CTA can compute BNAV in his disclosure document based solely on the amount deposited by the customer with the FCM.

If the CTA follows this course, there is no explicit requirement that he document in any way his agreement with the customer to base his trading decisions on some higher dollar figure. Although there is a general requirement that the CTA must provide the customer with "all other material information" not otherwise called for in the regulations, there is no explicit requirement that a CTA who follows this option must provide the customer with any disclosures regarding the possible effects of trading accounts on a nominal account size basis. Further, there is no requirement at all, specific or general, to inform the FCM clearing the customer's trades that the customer's account will be traded with a degree of leverage far greater than usually employed by the CTA.

This option does have the advantage of making the BNAV depicted in the CTA's disclosure document easy to verify during the audit process, but it can easily lead to a significant distortion of the past performance results reported to customers. For example, two customers who have committed the same amount of funds to the CTA to trade the same program at the same time could reflect widely divergent rates of return based solely on their own different cash management strategies -- a factor which has nothing at all to do with the CTA's trading decisions and which, therefore, does not create a track record reflective of the CTA's performance.

2) The CTA can present two separate performance tables for each program, excluding nominally funded amounts in one and including them in the other.

As with the first option, there are still no explicit requirements for the CTA regarding the documentation of the customer's agreement regarding nominal funds, additional disclosures which must be made to the customer or notice to the FCM. In addition, multiple tables reflecting widely different results for the same programs over the same time periods at best adds unnecessary bulk to the disclosure document and at worst creates the real potential for customer confusion.

3) The CTA may be able to present one performance table based on a fully funded subset of customer accounts.

This option was set forth in the Commission's most recent pronouncement regarding notional funding in Interpretive Letter 93-13. That interpretive letter does address the documentation and disclosure issues noted above, though only for those CTAs who choose to follow this third option. Even under this approach, however, there is still no notice given to the FCM. Moreover, the various tests and computations required to implement this option have proven in practice to be cumbersome and unwieldy, with the result that few CTAs have been able or willing to employ this option.

The Special Committee and the Board recognize the Commission's valid concerns regarding the documentation, disclosure and sales practice problems which notional funding of accounts can create. Over the years, however, experience has shown that these concerns are not at their core computational issues and that addressing those concerns through an interpretation of the definition of BNAV is not the most effective of dealing with them.

NFA believes that it would be more effective for customer protection to deal with these issues directly through an NFA Compliance Rule. The rule approved by our Board extends the documentation and disclosure requirements set forth in Commission Interpretive Letter 93-13 to all CTAs and eliminates the potentially distorted results or confusing multiplicity of tables allowed under the current interpretations.

Moreover, the rule approved by NFA's Board addresses several significant gaps in the current requirements. First, it requires that CTAs who agree to trade certain customer accounts with far more leverage based on the customer's written undertaking to commit more funds than have been deposited with the FCM to notify the FCM of that agreement. Ultimately, of course, it is the FCM's own capital which may be called upon if the customer reconsiders his commitment in the light of large margin calls. The FCM should be aware of the agreement so that it can make any adjustments to its margin policies it deems appropriate to safeguard its ability to fulfill its obligations to all of its customers.

NFA's rule will also provide needed protection to guard against potential abusive sales practices related to notional funding of accounts. Aggressive marketing of a notional funding program aimed at unsophisticated customers with limited means raises an array of problems which simply do not exist when the clients are large, institutional customers. NFA intends to notify all of its Members that the disclosures called for in the proposed compliance rule are the minimum disclosures which must be made and that the rule does not in any way relieve Members of their responsibilities under NFA Compliance Rule 2-30 or any other rule.

Under those rules any Member marketing a trading program to be traded on a nominal account size basis must collect certain required information regarding the customer's previous investment experience, income and net worth. In light of that information the Member must determine whether additional disclosures are required. In NFA's view, additional disclosures may well be required if customers of limited means and experience are being induced to agree to a higher degree of leverage by opening a nominally funded account. In some instances it may be necessary to disclose to the customer that trading on that basis may be too risky for that customer. Where such additional disclosures are required the Member must carefully document that they have, in fact, been provided.

For all of these reasons, NFA feels that the proposed Compliance Rule 2-34 and the accompanying interpretive notices represent a logical step forward in providing adequate customer protections without creating undue burdens on legitimate business activity.

Hypothetical Results

The issue of hypothetical trading results was of great concern to members of the Special Committee. For the purposes of its discussion, the Special Committee considered "hypothetical results" to consist of information which purports to show how a particular trading program would have performed in the past based on historical price movements. The Special Committee dealt with related topics, such as the use of pro forma and extracted results, separately.

As noted in the request for comment, many members of the Special Committee consider such hypothetical results to be potentially misleading. A pattern frequently seen in NFA disciplinary cases involves Members who tout new trading programs to unsophisticated customers by advertising hypothetical results, trade the program until there have been substantial customer losses and then turn to a new program with new hypothetical results, without ever disclosing the actual performance of his customers. In light of the inherent limitations of these "hindsight" trading results and the numerous instances of customer abuse, the Special Committee asked for comment on whether the use of hypothetical results should be completely prohibited.

There was a sharp division of thought in the comment letters which NFA received on this point. Five Members agreed that hypothetical results were inherently misleading and should be prohibited. Other commenters, however, suggested that in some circumstances hypothetical results, if used with the required disclaimers, could provide useful information to customers and that an absolute prohibition could make it more difficult for new CTAs to enter the industry.

The Special Committee and the Board considered all of these views and discussed the issue at great length, searching for an approach which would provide safeguards against potential customer abuse while limiting any potential anticompetitive effects. The Special Committee ultimately developed an approach which would avoid an outright prohibition, address the most common abuses and minimize any potential barriers to entry. Specifically, the Special Committee recommended an amendment to NFA Compliance Rules to provide that no Member -- regardless of category -- may use promotional material referring to hypothetical results unless the material also provides comparable information regarding the Member's actual trading results.

This approach would ensure that the customer would be able to judge the hypothetical results not only in the light of the limitations described in the CFTC's disclaimer, but also in light of the Member's past success in developing trading programs for customers or for proprietary trading. The burden imposed on new CTAs should be minimal since only those CTAs with less than one year of experience in some form of actual trading would be affected. Furthermore, the limitations imposed by the rule would not apply at all to materials provided to individuals who meet the standards set for Qualified Eligible Participants in CFTC Regulation 4.7.

The Special Committee and the Board firmly believe that this proposal represents a surgical approach which addresses a practice which has been the subject of abuse for too long while imposing minimal limitations on legitimate business activity.

Pro Forma and Extracted Results

The Special Committee agreed that the use of pro forma performance histories can present useful information to customers, particularly when used to show how the past performance of a given CPO or CTA would have been affected by the fee structure of the current offering. In other instances, however, the use of pro forma results carry some of the same limitations as hypothetical results. For example, some CPOs have used "pro forma" results to show what results a multi-advisor pool could have achieved in the past if the pool's assets had been allocated among certain CTAs in a certain proportion. This use of pro forma results reflects the same sort of hindsight analysis that hypothetical results do and invites the same sort of abuse. The Special Committee would, therefore, not allow this particular use of pro forma results.

Hindsight analysis may also play a part in the presentation of "extracted performance" in which a CTA selects one component of its overall past trading results to highlight to customers. In the Special Committee's view, this use of extracted performance should be permitted only when the CPO or CTA had designated in previous disclosure documents the percentage of assets which would be committed toward that particular component of the overall trading program.

Break-Even Analysis

The guiding principle behind all of the Special Committee's recommendations is that the customer's attention should be focused on the information which is most material to his investment decision. The Special Committee recognizes that information about fees and expenses is particularly important to customers, but too often the narrative description of the fees set forth in disclosure documents is both long and confusing. The information most important to the customer is simply what kind of trading results his investment must generate to overcome the expenses he is being charged. The most effective way to communicate this information to customers is through a simple tabular presentation. This sort of break-even analysis is already widely used in the industry and in the Special Committee's view it should be mandatory. The Special Committee, therefore, recommends that each CPO be required to include in its disclosure documents a table reflecting all of the fees and expenses and the trading profits necessary in the first year of trading to recoup the customer's initial investment. Though the comment letters did not focus on this issue, all of the Advisory Committees strongly supported this recommendation.

Civil Litigation and Business Background of Principals

The Special Committee agreed that current disclosure requirements regarding civil litigation involving FCMs which carry the pool's or the CTA's accounts are overbroad. All FCMs of any significant size are involved in a certain amount of customer litigation. In the Special Committee's view most of the information concerning that litigation has little or no value to the prospective customer but often adds substantially to the length of the disclosure document. The Special Committee therefore proposed that the only civil litigation involving the FCM which should be relevant to prospective customers and therefore disclosed in the disclosure document is litigation which could threaten the financial viability of the FCM.

Commenters generally supported this concept, but the FCM Advisory Committee felt that the "financial viability of the FCM" standard is too vague. As an alternative, the FCM Advisory Committee suggested that CPOs and CTAs should only be required to disclose civil litigation of the FCM which the FCM itself must disclose on its financial statements under Generally Accepted Accounting Principles. The Special Committee agrees with that recommendation.

The Special Committee also concluded that providing detailed information on the business background of all of the principals of the CPO and CTA for the last five years provides little useful information to prospective customers and adds substantially to the length of disclosure documents. Many of the principals whose background must be disclosed have little or nothing to do with the day-to-day operations of the CPO or CTA. The Special Committee suggested that the disclosure of business background focus on those individuals who truly exercise a controlling influence on the management of the CPO or CTA. In response to comments received, the Special Committee would clarify that this includes individuals with responsibility for developing trading strategies, making trading decisions and allocating assets among CTAs.

II. TEXT OF PROPOSED AMENDMENTS AND INTERPRETIVE NOTICES

(Additions are underscored and deletions are bracketed)

COMPLIANCE RULES

* * *

Part 2 -- RULES GOVERNING THE BUSINESS CONDUCT OF MEMBERS REGISTERED WITH THE COMMISSION

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Rule 2-13. CPO/CTA REGULATIONS

(a) Any Member who violates any of CFTC Regulations 4.1 and 4.16 through 4.41 shall be deemed to have violated an NFA requirement.

(b) Each Member CPO or CTA which delivers or causes to be delivered a Disclosure Document under CFTC Regulation 4.21 or 4.31 must present past performance information in the manner prescribed by NFA's Board of Directors.

(c) Each Member CPO which delivers or causes to be delivered a Disclosure Document under CFTC Regulation 4.21 must include in the Disclosure Document a break-even analysis which includes a tabular presentation of fees and expenses. The break-even analysis must be presented in the manner prescribed by NFA's Board of Directors.

(d) Each Member required to file any document with or give notice to the CFTC under CFTC Regulations 4.13 and 4.16 through 4.32 shall also file one copy of such document with or give such notice to NFA at its Chicago office no later than the date such document or notice is due to be filed with or given to the CFTC. Any CPO Member may file with NFA a request for an extension of time in which to file the annual report required by CFTC Regulation 4.22(c) or a request for approval of a change to its fiscal-year election by following the procedures set forth in NFA Financial Requirements Schedule E.

* * *

Rule 2-29. COMMUNICATIONS WITH THE PUBLIC AND PROMOTIONAL MATERIAL.

* * *

(b) Content of Promotional Material.

No Member or Associate shall use any promotional material which:

(1) is likely to deceive the public; or

(2) contains any material misstatement of fact or which the Member or Associate knows omits a fact if the omission makes the promotional material misleading; or

(3) mentions the possibility of profit unless accompanied by an equally prominent statement of the risk of loss; or

[(4) includes a measurement or description of or makes any reference to hypothetical results which could have been achieved had a particular trading system been employed in the past unless accompanied by the statement prescribed in CFTC Rule 4.41(b)(1); or]

[(5)] (4) includes any reference to actual past trading profits without mentioning that past results are not necessarily indicative of future results; or

[(6)] (5) includes any specific numerical or statistical information about the past performance of any actual accounts (including rate of return) unless such information is and can be demonstrated to NFA to be representative of the actual performance for the same time period of all reasonably comparable accounts and, in the case of rate of return figures, unless such figures are calculated in a manner consistent with that required under CFTC Rule 4.21(a)(4)(ii)(F).

(c) **Hypothetical Results.**

(1) Except as provided below in paragraph (3), no Member or Associate may use promotional material which includes a measurement or description of or makes any reference to hypothetical results which could have been achieved had a particular trading system been employed in the past unless the Member has at least one year of experience in directing the trading in customer accounts pursuant to a power of attorney or in trading the Member's proprietary trading accounts.

(2) Any Member or Associate who uses promotional material which includes a measurement or description of or makes any reference to hypothetical results which could have been achieved had a particular trading system been employed in the past must include in the promotional

material the statement prescribed in CFTC Rule 4.41(b)(1).

(3) Any Member or Associate who uses promotional material which includes a measurement or description of or makes any reference to hypothetical results which could have been achieved had a particular trading system been employed in the past must include in the promotional material comparable information regarding:

(i) past performance results of all customer accounts directed by the Member pursuant to a power of attorney over the lesser of the last five years or the entire performance history, and

(ii) if the Member has less than one year experience in directing customer accounts, past performance results of his proprietary trading over the lesser of the last five years or the entire performance history.

(4) These restrictions on the use of hypothetical trading results shall not apply to promotional material directed exclusively to persons who meet the standards of a "Qualified Eligible Participant" under CFTC Rule 4.7.

[(c)] (d) **Statements of Opinion.**

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[(d)] (e) **Written Supervisory Procedures.**

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[(e)] (f) **Recordkeeping.**

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[(f)] (g) **Filing with NFA.**

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[(g)] (h) **Definition.**

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Rule 2-34. DIRECTED ACCOUNTS AND COMMODITY POOLS

(a) At the time a Member CTA enters into an agreement to direct a client's account, the Member CTA must obtain a written agreement signed by the client (or someone legally authorized to act on the client's behalf) which states:

(1) the amount of funds the client agrees to commit to the CTA's management;

(2) the name or description of the trading program the client is participating in;

(3) whether the client intends to deposit or maintain with the FCM an amount equal to the amount committed; and

(4) how profits and losses will affect the amount committed to trading.

The Member CTA must provide a copy of the agreement to the FCM carrying the account.

(b) Unless the client is a qualified eligible client or the pool participants are qualified eligible participants under CFTC Regulation 4.7, any Member CTA which directs an account for which the agreement states that the client does not intend to deposit or maintain with the FCM the entire amount committed to trading and any Member CPO which allocates assets among CTAs in such a way that the total committed is greater than the total assets of the pool must provide the following information in writing to the client or the pool participants, respectively:

(1) a clear statement of how the management fees will be computed in relation to the amount of funds committed to trading;

(2) for CTAs, a statement that commissions and fees will be a greater percentage of the funds on deposit than if the client deposited or maintained with the FCM the entire amount committed;

(3) for CPOs, a statement that commissions and fees will be a greater percentage of the assets of the pool than if the pool assets were allocated differently; and

(4) for CTAs, the effect of partial funding levels on the frequency and amount of margin calls.

(c) Each CTA Member which directs accounts and each CPO Member which allocates assets among CTAs in such a way that the total committed is greater than the total assets of the pool shall maintain the records required by this Rule in the form and for the period of time required by CFTC Regulation 1.31.

(d) Each CTA Member which directs accounts and each CPO Member which allocates assets among CTAs in such a way that the total committed is greater than the total assets of the pool shall establish and enforce adequate procedures to review all records made pursuant to this Rule and to supervise the activities of its Associates in complying with this Rule.

(e) Nothing herein shall relieve any Member of the obligation to comply with all applicable CFTC Regulations and NFA Requirements.

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INTERPRETATION OF NFA COMPLIANCE RULE 2-13

PRESENTATION OF PAST PERFORMANCE INFORMATION

CFTC Regulations 4.21 and 4.31 require commodity pool operators ("CPOs") and commodity trading advisors ("CTAs") to prepare a disclosure document and provide it to potential pool participants and clients when soliciting pool participations or accounts to direct or guide or when accepting funds or entering into an agreement with a client. Those requirements have been incorporated into NFA Compliance Rule 2-13. This notice, which is issued under section (b) of that rule, describes the method which must be used when presenting past performance information. All Member CPOs and CTAs must comply with this interpretive notice when preparing and using the disclosure documents required by CFTC Regulations 4.21 and 4.31.[1]

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[1] This interpretive notice does not apply to disclosure documents and other promotional material prepared and used exclusively in connection with exempt pools or exempt accounts as those terms are defined in CFTC Regulation 4.7.

The purpose of disclosure documents is to ensure that customers are provided with sufficient information to make an informed investment decision. In order to achieve this goal, disclosure documents must not only present all material information but must do so in a clear and concise manner which can be understood by the average investor. With these principles in mind, NFA's Board of Directors has adopted the following requirements for presenting past performance information in disclosure documents.

I. HOW PAST PERFORMANCE INFORMATION SHOULD BE PRESENTED

Past performance information should be easily understood and evaluated without having to wade through page after page of complex tables. The Board of Directors believes that capsule descriptions of the past performance of pools and trading programs are much more "user friendly" than lengthy tables. Therefore, the Board of Directors has adopted a capsule format which contains all of the performance information which sophisticated customers consider material in making an investment decision.

A. CPO Performance

The capsule descriptions for CPOs and their principals must contain the following information:

1. The name of the fund (or funds if the capsule is a composite);
2. A brief description of the fund (i.e., guaranteed fund, single advisor non-guaranteed fund, non-guaranteed fund with more than one advisor);
3. Date the fund began trading (or, for a composite, date the first fund began trading);
4. Initial capitalization;
5. Current capitalization;
6. Compound rate of return;
7. Best return for any complete calendar year;
8. Worst return for any complete calendar year;
9. Worst peak to valley;
10. Worst monthly drawdown; and
11. Current year-to-date return based on a calendar year.

The Board of Directors has not adopted a specific format for presenting this information but has left the exact method of presentation to the CPO's discretion. However, all of the required information must be easy to find and interpret, and, as always, the information may not be presented in a misleading manner. The rate of return information must be calculated in a manner approved by the Commodity Futures Trading Commission ("Commission").

The CPO is required to maintain supporting documentation for all of the information to be included in the capsule and to make the supporting documentation available to the Commission and NFA upon request. The supporting documentation must be sufficient to allow the Commission or NFA to calculate and determine beginning net asset value, additions, withdrawals, net performance, ending net asset value, rate of return, and number of units outstanding on a monthly or quarterly basis.

B. **CTA Performance**

The capsule descriptions for CTAs and their principals must contain the following information:

1. The name of the trading program;
2. A brief description of the trading program (e.g., technical or fundamental, commodities traded, minimum account size);
3. Date the program began trading with customer funds;
4. Customer funds committed to trading when the program began (including nominal funds);
5. Current customer funds committed to trading (including nominal funds);
6. Compound rate of return;
7. Best return for any complete calendar year;
8. Worst return for any complete calendar year;
9. Worst peak to valley;
10. Worst monthly drawdown; and
11. Current year-to-date return based on a calendar year.

As long as the required information is easy to find and interpret, CTAs may present the capsule information in any manner which is not misleading. The rate of return information must be calculated in a manner approved by the Commission and must be based on the entire amount of funds committed to trading (i.e., nominal account size).

As with CPOs, CTAs are required to maintain supporting documentation for all of the information to be included in the capsule and must make the supporting documentation available to the Commission and NFA upon request. The supporting documentation must be sufficient to allow the Commission or NFA to calculate and determine beginning net asset value, additions, withdrawals, net performance, ending net asset value, and rate of return on a monthly or quarterly basis.

II. WHAT PAST PERFORMANCE MUST BE DISCLOSED

Although all past performance information may have some relevance to an investor or potential investor, the more removed the information is from the product being offered, the more likely it is to confuse rather than enlighten the investor. Therefore, the Board of Directors has determined that only past performance data which would be considered important by a sophisticated investor must be disclosed.

The following paragraphs describe what past performance data is relevant and, therefore, must be disclosed. Except as provided in NFA Compliance Rule 2-29, other past performance information may be disclosed if it is not misleading and does not lessen the impact of the required information.

A. CPO Disclosure Documents

The Board of Directors recognizes that the past performance of pools which are of a different type than the pool being offered has limited relevance to the decision to invest in that pool. Including the past performance of dissimilar pools not only adds clutter to the disclosure document but could actually be misleading. At the same time, the Board of Directors is concerned that a CPO with consistently poor performance in one type of fund should not be allowed to hide its performance simply by switching formats. In short, the customer's attention should be focused on the past performance of the CPO's pools which are similar to the current offering but, where the pool itself does not have an adequate history, the customer should also be informed of the past performance of other pools operated by the CPO.

The pool being offered and other pools of the same type should each have a separate capsule description. Pools which are of a different type than the pool being offered should be included in a composite capsule with other pools of the same type. In this connection, the Board of Directors recognizes the following types of pools:

1. Guaranteed funds;
2. Single-advisor (non-guaranteed) funds; and
3. Non-guaranteed funds with two or more advisors.

However, material differences between pools in the same category must be footnoted.

If a CPO has less than three years of experience, the CPO must disclose the performance of pools operated by its principals. As with the performance of the CPO itself, there must be a separate capsule for each pool operated by a principal of the CPO and composite capsules for other pools operated by that principal. For purposes of this interpretation, a principal is a person who truly exercises a controlling influence on the management of the CPO or CTA, which includes individuals with responsibilities for developing trading strategies, making trading decisions, or allocating assets among CTAs.

The disclosure document for a single-advisor fund or a fund with two or more advisors which is not considered a multi-advisor fund must disclose the performance records of the pool's CTA(s) and the CTA's principals. A separate capsule description must be provided for each trading program. For purposes of this interpretation, a multi-advisor fund is any pool with three or more CTAs, none of whom controls more than 50% of the pool's assets.

Although the Board of Directors realizes that the performance of the CTAs who trade on behalf of a multi-advisor fund is not entirely irrelevant to a decision to invest in that fund, the Board of Directors feels that the more meaningful inquiry is based on the CPO's ability to select CTAs and allocate assets among them. Therefore, the disclosure document for a multi-advisor fund does not have to include the performance of the pool's CTAs.

If a CPO with less than three years of experience operating multi-advisor funds presents information on the past performance of a multi-advisor fund's CTAs, that information must be accompanied by the following disclaimer:

> YOU SHOULD BE AWARE THAT THE POTENTIAL SUCCESS OF THIS POOL WILL DEPEND TO A GREAT EXTENT ON THE CPO'S ABILITY TO ALLOCATE FUNDS ON A CONTINUING BASIS TO CTAS THAT WILL TRADE PROFITABLY FOR THE POOL. YOU SHOULD ALSO BE AWARE THAT THE CPO HAS LIMITED (OR NO) PRIOR EXPERIENCE MAKING SUCH ALLOCA-

TION DECISIONS. AS A GENERAL MATTER A CTA'S PAST TRADING RESULTS ARE NOT NECESSARILY INDICATIVE OF FUTURE RESULTS. THIS IS PARTICULARLY TRUE FOR A COMMODITY POOL IN WHICH THE CPO HAS LIMITED PREVIOUS EXPERIENCE. THEREFORE, YOU SHOULD NOT PLACE UNDUE RELIANCE ON THE CTA PERFORMANCE HISTORIES SET FORTH IN THIS DISCLOSURE DOCUMENT.

If an open-ended pool has been in operation for three years or more, the most meaningful past performance information relates to the performance of the pool itself. Therefore, if a pool has been in operation for three years or more, the pool's disclosure document does not have to include performance information on the other pools operated by the CPO or its principals or on programs managed by the pool's CTA or its principals. The only past performance information which the pool is required to include in its disclosure document is the performance of the pool itself.

B. **CTA Disclosure Documents**

In presenting past performance information, each trading program of the CTA or its principals must have a separate capsule description. Proprietary trading results may not be included in a capsule composite with customer trading results. Proprietary trading results may be displayed separately if they are clearly labeled as proprietary trading results and appropriate disclosures are made for fee differentials and other differences such as leverage and account size.

C. **Pro Forma and Extracted Results**

The Board of Directors believes that the use of pro forma performance histories can present useful information to customers, particularly when used to show how the past performance of a given CPO or CTA would have been affected by the fee structure of the current offering. Therefore, a CPO or CTA may use pro forma results to adjust for differences in fees as long as the pro forma results are not calculated in a misleading manner.

CPOs and CTAs may not use pro forma results which reflect a hindsight analysis. For example, CPOs may not use pro forma results to show what results a multi-advisor pool could have achieved in the past if the pool's assets had been allocated among particular CTAs in a certain proportion.

Hindsight analysis may also play a part in the presentation of "extracted performance" in which a CTA selects one component of its overall past trading results to highlight to customers. In order to limit the effect of hindsight, the use of extracted performance is permitted only when the CPO's or CTA's previous disclosure documents designated the percentage of assets which would be committed toward that particular component of the overall trading program. For example, if the previous disclosure document stated that 25% of a fund's assets would be dedicated to trading financial futures contracts, and if 25% of the fund's assets were in fact dedicated to trading financial futures contracts, the CPO would be allowed to present the extracted performance of its financial futures trading based on net asset values equal to 25% of the fund's total net asset value.

III. TIME PERIOD FOR PAST PERFORMANCE INFORMATION

The disclosure document must include performance information for the last five years or the entire performance history, whichever is shorter. A CPO or CTA may disclose more than five years of past performance as long as the additional time period is not misleading. A CPO or CTA may not present past performance information which is not representative of the CPO's or CTA's overall performance or which contains gaps. For example, if a CPO or CTA chooses to present past performance information from the past ten years, the performance over ten years must be similar to the overall performance of the pool or trading program and the entire ten year period must be included.

IV. OTHER PROMOTIONAL MATERIAL

Advertisements and other materials designed to market a particular commodity pool or trading program must be derived from the information in the disclosure document required by CFTC Regulation 4.21 or 4.31. For example, if a CPO or CTA includes five years of performance history in the disclosure document, the CPO or CTA cannot use promotional material which includes a different period. Furthermore, if there are restrictions on the use of performance information in the disclosure document, those same restrictions apply to other promotional materials (e.g., a CTA cannot include proprietary trading results with customer results).

V. PUBLIC FUNDS

The Board of Directors realizes that public funds are also required to comply with the requirements of the Securities and Exchange Commission ("SEC") and the various states. A public fund which is operated by a CPO Member of NFA must comply with this interpretation whenever possible. However, where the SEC or a state requires performance information to be presented in a manner which conflicts with this interpretation, the CPO may comply with the SEC or state requirements without violating NFA Compliance Rule 2-13. In that event, the CPO must maintain records showing that its failure to comply was due to inconsistent SEC or blue sky requirements.

VI. CONCLUSION

The purpose of this interpretation, and of the disclosure document requirements in general, is to enhance investor protection by providing investors and potential investors with an understandable disclosure document which is short enough to be readable but complete enough to provide investors and potential investors with the information they need to make an informed investment decision. However, a CPO or CTA may not rely on technical compliance with this interpretation but must also include any additional information or disclaimers necessary to ensure that the information provided in the disclosure document is not misleading. Furthermore, past performance information which is not required under this interpretation may be disclosed only if it is not misleading and does not lessen the impact of the required information.

# # #

INTERPRETATION OF NFA COMPLIANCE RULE 2-13

BREAK-EVEN ANALYSIS

NFA Compliance Rule 2-13 requires, in pertinent part, that each Member CPO which delivers a disclosure document under the CFTC Regulation 4.21 must include in the disclosure document a break-even analysis which includes a tabular presentation of fees and expenses. The break-even analysis must be presented in the manner prescribed by NFA's Board of Directors. The purpose of this requirement is to ensure not only that customers will be clearly informed as to the nature and amount of fees and expenses that will be incurred, but that customers will also be made aware of the impact of those fees and expenses on the potential profitability of their investments. NFA's Board of Directors has adopted the following guidelines which must be adhered to by NFA Member CPOs when preparing the break-even analysis required by Compliance Rule 2-13:

- If fees are likely to be affected by the size of the offering, then an assumed amount of total funds raised should be stated. The document should also state what the break-even point would be if the minimum or maximum proceeds were raised.

- If there are redemption fees, they must be clearly shown and considered part of the total cost and reflected in the break-even analysis.

- Incentive fees should be stated as a percentage of profits, and the method by which profits are calculated should be described.

- All management, brokerage and other fees should reflect actual experience or contractual charges, if known. If not known, they should be based on good faith estimates. If, for example, CTAs publish their estimated number of round turns/ $1,000,000 then those published estimates should be used for estimating brokerage costs. If this is an on-going fund or if there is evidence supporting other numbers, then the other numbers should be used and explained.

To calculate the break-even point a CPO must first determine the amounts of all fees and expenses, exclusive of incentive fees, that are anticipated to be incurred by the pool during the first year of the investment. The total of these fees and expenses less the amount of interest income expected to be earned by the pool represents the gross trading profits before incentive fees (preliminary gross trading profits) that would be necessary for the pool to retain its initial Net Asset Value per unit at the end of the first year. The CPO must then calculate the additional trading profit that would be necessary to overcome the incentive fees that would be incurred. That amount can be computed by first determining the incentive fees that would be incurred if the preliminary gross trading profits described above were achieved and then dividing that amount by (1- incentive fee rate); e.g., if the incentive fee is 25%, the denominator would be 1- .25, or .75. A sample break-even presentation is shown below:

Selling Price per unit (1)		$ 1,000.00
Syndication and selling expense (1)	$	50.00
General Partner's management fee (2)		9.50
Fund operating expenses (3)		20.50
Trading Advisor's and Trading Manager's management fees (4)		28.50
Trading Advisor's and Trading Manager's incentive fees on trading profits (5)		17.17
Brokerage commissions and trading fees (6)		38.00
Less interest income (7)		(28.50)
Amount of trading income required for the Fund's Net Asset Value per unit (redemption value) at the end of one year to equal the Selling Price per unit	$	135.17
Percentage of initial Selling Price per unit		13.52%

Explanatory Notes:

(1) Investors will initially purchase units at $1,000. After the commencement of trading, units will be purchased at the Fund's month-end Net Asset Value per unit. A 5% syndication and selling charge will be deducted from each subscription to reimburse the Fund, the General Partner and/or the Clearing Broker for the syndication and selling expenses incurred on behalf of the Fund.

(2) Except as set forth in these explanatory notes, the illustration is predicated on the specific rates or fees contracted by the Fund with the General Partner, the Trading Manager, the Trading Advisor, and the Clearing Broker, as described in "Fees, Compensation and Expenses."

(3) The Fund's actual accounting, auditing, legal and other operating expenses will be borne by the Fund. These expenses are expected to amount to approximately 2.05% of the Fund's Net Asset Value.

(4) The Fund's Trading Advisor will be paid a monthly management fee of 1/2 of 2% of Allocated Net Assets. The fund's Trading Manager will be paid a monthly management fee of 1/12 of 1% of allocated Net Assets.

(5) The Trading Advisor and Trading Manager will receive incentive fees of 20% and 5%, respectively, of Trading Profits exclusive of interest income. The $17.17 of incentive fees shown above is equal to 25% of the net of total trading income of $135.17, minus $38.00 of brokerage commissions and trading fees and $28.50 of management fees.

(6) Brokerage commissions and trading fees are estimated at 4% of Net Asset Value.

(7) The Fund will earn interest on margin deposits with its Clearing Broker. Based on current interest rates, interest income is estimated at 3% of Net Asset Value.

# # #

NFA respectfully requests that the Commission review and approve the proposed amendments to NFA Compliance Rules 2-13 and 2-29, adoption of NFA Compliance Rule 2-34 and Interpretive Notices to NFA Compliance Rule 2-13. NFA requests that the amendments, new rule and interpretive notices be declared effective upon Commission approval.

Sincerely,

Daniel J. Roth
General Counsel

DJR:ckm(sub\speccom)

cc: Acting Chairman Barbara Pedersen Holum
Commissioner Sheila C. Bair
Commissioner Joseph P. Dial
Commissioner John E. Tull, Jr.
Andrea M. Corcoran, Esq.
Dennis P. Klejna, Esq.
Alan L. Seifert, Esq.
Susan C. Ervin, Esq.
Lawrence B. Patent, Esq.
David Van Wagner, Esq.

NATIONAL FUTURES ASSOCIATION
200 W. MADISON ST. • CHICAGO, IL • 60606-3447 • (312) 781-1300

March 30, 1994

Via Facsimile and Regular Mail

Andrea M. Corcoran, Esq.
Division of Trading & Markets
Commodity Futures Trading Commission
2033 K Street, N.W.
Washington, D.C. 20581

Dear Andrea:

Confirming our recent conversation, NFA staff will recommend that the Board act at its May 19 meeting to amend the proposed changes to NFA Compliance Rule 2-13 which are currently pending approval before the Commission. Specifically, we will recommend that the Board approve an amended version of NFA Compliance Rule 2-13 to read as follows (additions are underscored):

COMPLIANCE RULES

* * *

Part 2 -- RULES GOVERNING THE BUSINESS CONDUCT OF MEMBERS REGISTERED WITH THE COMMISSION

* * *

Rule 2-13. CPO/CTA REGULATIONS

<u>(a)</u> Any Member who violates any of CFTC Regulations 4.1 and 4.16 through 4.41<u>, including any interpretation of those regulations issued by NFA's Board of Directors and approved by the CFTC,</u> shall be deemed to have violated an NFA requirement.

<u>(b) Each Member CPO which delivers or causes to be delivered a Disclosure Document under CFTC Regulation 4.21 must include in the Disclosure Document a break-even analysis which includes a tabular presentation of fees and expenses. The break-even analysis must be presented in the manner prescribed by NFA's Board of Directors.</u>

<u>(c)</u> Each Member required to file any document with or give notice to the CFTC under CFTC Regulations 4.13 and 4.16 through 4.32 shall also file one copy of such document with or give such notice to NFA at its Chicago office no later than the date such document or notice is due to be filed with or given to the CFTC. Any CPO Member may file with NFA a request for an extension of

NFA

time in which to file the annual report required by CFTC Regulation 4.22(c) or a request for approval of a change to its fiscal-year election by following the procedures set forth in NFA Financial Requirements Schedule E.

If you have any further questions regarding this matter, please do not hesitate to call me.

Sincerely,

Daniel J. Roth
General Counsel

DJR:ckm(ltr\ac2-13)

NATIONAL FUTURES ASSOCIATION
200 W. MADISON ST. • CHICAGO, IL • 60606-3447 • (312) 781-1300

May 27, 1994

Ms. Jean A. Webb
Secretariat
Commodity Futures Trading Commission
2033 K Street, N.W.
Washington, D.C. 20581

Re: National Futures Association: Proposed Amendments to NFA Compliance Rule 2-13

Dear Ms. Webb:

By letter dated March 15, 1994, National Futures Association ("NFA") submitted to the Commodity Futures Trading Commission ("CFTC") for its review and approval proposed amendments to NFA Compliance Rules 2-13 and 2-29 and proposed adoption of NFA Compliance Rule 2-34 and certain Interpretive Notices, all of which were based on recommendations from NFA's Special Committee for the Review of CPO/CTA Disclosure Issues and approved by NFA's Board of Directors.

Since that time, Commission staff raised a technical issue concerning the exact language of NFA's proposed amendments to Rule 2-13. NFA was in agreement with the recommendations made by Commission staff, and on May 19, 1994, NFA's Board approved amendments to Rule 2-13 incorporating those recommendations.

NFA hereby substitutes the text of NFA Compliance Rule 2-13 contained in the March 15, 1994 submission letter with the proposed text set forth below.

THE PROPOSED AMENDMENTS

The proposed amendments to NFA Compliance Rule 2-13 are as follows (additions are underscored and deletions are bracketed):

COMPLIANCE RULES

* * *

Part 2 -- RULES GOVERNING THE BUSINESS CONDUCT OF MEMBERS REGISTERED WITH THE COMMISSION

* * *

NFA

Ms. Jean A. Webb May 27, 1994

Rule 2-13. CPO/CTA REGULATIONS.

(a) Any Member who violates any of CFTC Regulations 4.1 and 4.16 through 4.41, including any interpretation of those regulations issued by NFA's Board of Directors and approved by the CFTC, shall be deemed to have violated an NFA requirement.

(b) Each Member CPO which delivers or causes to be delivered a Disclosure Document under CFTC Regulation 4.21 must include in the Disclosure Document a break-even analysis which includes a tabular presentation of fees and expenses. The break-even analysis must be presented in the manner prescribed by NFA's Board of Directors.

(c) Each Member required to file any document with or give notice to the CFTC under CFTC Regulations 4.13 and 4.16 through 4.32 shall also file one copy of such document with or give such notice to NFA at its Chicago office no later than the date such document or notice is due to be filed with or given to the CFTC. Any CPO Member may file with NFA a request for an extension of time in which to file the annual report required by CFTC Regulation 4.22(c) or a request for approval of a change to its fiscal-year election by following the procedures set forth in NFA Financial Requirements Schedule E.

* * *

Respectfully submitted,

Daniel J. Roth
General Counsel

DJR:ckm(sub\051994.213)

cc: Acting Chairman Barbara Pedersen Holum
Commissioner Sheila C. Bair
Commissioner Joseph P. Dial
Commissioner John E. Tull, Jr.
Andrea M. Corcoran, Esq.
Dennis P. Klejna, Esq.
Alan L. Seifert, Esq.
Susan E. Ervin, Esq.
Lawrence B. Patent, Esq.
David Van Wagner, Esq.

COMMODITY FUTURES TRADING COMMISSION
2033 K Street, NW, Washington, DC 20581
(202) 254 - 8955
(202) 254 - 8010 Facsimile

DIVISION OF
TRADING AND MARKETS

June 10, 1994

RECEIVED
JUN 14 1994
GENERAL COUNSEL'S OFFICE

Mr. Daniel J. Roth
General Counsel
National Futures Association
200 West Madison Street
Chicago, Illinois 60606-3447

Re: Proposed National Futures Association Compliance Rule 2-34 -- Nominal Account Size

Dear Mr. Roth:

By letter dated March 15, 1994, and received by the Commission on March 17, 1994, the National Futures Association ("NFA") submitted to the Commission for its approval, pursuant to Section 17(j) of the Commodity Exchange Act ("Act"), a proposed new rule and various proposed rule amendments and rule interpretations which would establish disclosure requirements for commodity pool operators ("CPOs") and commodity trading advisors ("CTAs"). The proposal would, among other things, require the use of the so-called notional funds method to present past performance in CPO and CTA disclosure documents. Based upon its review, the Division of Trading and Markets ("Division") has identified the following matters which NFA should address in order to explain and justify further the proposed CPO and CTA disclosure requirements. These matters are arranged by general topic.

I. <u>CLARIFICATIONS AND ADDITIONAL INFORMATION</u>

The Division requests clarification or additional information for the following matters.

1. Proposed new Compliance Rule 2-34(a)(1) refers to the amount of "funds" that a customer agrees to commit to a CTA's management, while section (b) of the Rule refers to the amount of "assets" that a member CPO allocates among CTAs "in such a way that the total committed is greater than the total assets of the pool." Please confirm our understanding that in this context "funds" and "assets" are both synonymous with "nominal account size" as described in Commission Advisory 93-13.

2. Under the notional funds method, the amount of the "commitment" to the CTA's program is based on an amount specified in the customer agreement. Please address whether, under the NFA proposal, a customer would be

required to have any particular amount of tangible financial resources to support or fund the amount of the commitment.

3. Please explain how proposed Rule 2-34's use of the term "amount committed" would relate to its common use in a financial accounting context.

4. The Association for Investment Management and Research ("AIMR") requires rates of returns ("RORs") to be computed on an unleveraged basis; that is, in the case of a security purchased on margin, the ROR would be based upon the total value of the security. In the case of derivatives, the comparable amount would appear to be the value of the securities or cash commodity from which the derivative is derived. How does NFA's proposed use of the notional funds method compare to the AIMR standard?

5. Under the proposed notional funds method, there appears to be no explicit requirement for a fully-funded subset, as specified in Commission Advisory 93-13.[1/] Please explain how the proposal would address a situation in which the maximum percentage funding level by any retail customer of a CTA was 50% of the nominal account size, so that the CTA had no fully-funded retail accounts.

6. In the hypothetical situation from question 5 above, assuming a maximum of 50% funding for any account, does NFA believe it would be misleading for a CTA to claim it had funds under management based upon nominal account sizes?

7. In its submission, NFA indicates that the use of notional funds would require special care to ensure that retail customers fully understand all the ramifications of such accounts. NFA does not appear to make explicit what disclosures would be required. Please compare the NFA proposal to the requirements of Advisory 93-13, indicating exactly which would be retained and which would be deleted, and include an explanation for the deletion of any requirement. For example, please compare the respective requirements of the proposal and Advisory 93-13 with regard to: (a) the amount of actual funds with which the customer intends to fund the account, (b) the actual funds under management, (c) the fees as a percentage of actual funds, and (d) the need for a fully-funded subset.

II. <u>DIFFERING OBJECTIVES FOR DIFFERENT TYPES OF CUSTOMERS</u>

NFA's submission refers to the treatment of different types of customers, including sophisticated and retail customers. In this connection, please address the following matters.

[1/] 58 <u>Fed</u>. <u>Reg</u>. 8226 (February 12, 1993).

8. Please address disclosure and other issues presented by a retail customer participating in a CTA's program on a partially-funded basis, as compared to a fully-funded basis.

9. In its proposal, the NFA states that sophisticated customers often maintain only minimum amounts of margin in their commodity interest trading accounts and that as a result the ROR computation method required by the Commission, referred to as the "actual funds" method in Advisory 93-13, yields distorted results for such accounts. The NFA asserts that its proposed notional funds method would be a better means of presenting the performance of the accounts of such sophisticated customers than the actual funds method. However, customers thought to be "sophisticated" generally are Regulation 4.7 qualified eligible participants ("QEPs"). CTAs trading accounts of QEPs are not subject to the specific requirements of Commission rules in presenting performance to such persons. Please explain why NFA would mandate any particular reporting standard for such accounts.

III. COMPARING THE NOTIONAL FUNDS METHOD AND THE ACTUAL FUNDS METHOD

Please address the following issues that are raised by a comparison of the present Commission-mandated actual funds method and the NFA's proposed notional funds method.

10. Under the actual funds method, assuming a constant level of futures trading and profits and losses experienced in accounts traded with the same number of contracts, the month-to-month percentage changes in account equity would be proportionately larger for accounts funded with less margin funds. The amount of margin funds in an account is a function of how much money the customer has deposited, plus or minus profits and losses. The amount of such actual funds is readily subject to verification. How would the notional account size be verified at any particular point in time and over time?

11. It is commonly assumed that customers prefer low levels of fluctuation of return and are attracted to low percentage management fees. In this connection, if NFA were to establish no requirement for a fully-funded subset, what would prevent a CTA from establishing relatively high nominal account sizes to give the appearance of a smooth rate of return and a low percentage fee?

12. In comparison to the actual funds method, how well would the notional funds method convey the impact of materially different levels of leverage among various customers' accounts, between accounts of varying degrees of leverage and from one historical period to another?

IV. SYSTEMIC AND PARTICULAR RISK

The following matters pertain to the level of risk, if any, that NFA's proposal would pose to the market and market participants.

13. (a) Under the proposed notional funds method, it appears that a CTA would not be required to obtain from its customers the amount of actual funds allocated to the trading program, and that the CTA, therefore, may only be aware of the trading level selected by the customer. Without the disclosure of the amount of actual funds allocated to the CTA, which is presently required by Advisory 93-13, it would seem that customers who are pools could "allocate" to their CTAs many times the amount of actual funds in their possession without the knowledge of the CTAs. That is, the traders of the pool's assets would be unaware of the true amount they were leveraging the pool's assets because they would not know the actual amount of the assets. Please address the reasons for permitting CPOs to allocate more assets than are contained in a pool and what disclosures would be made to CTAs.

    (b) Has the NFA encountered this practice in its audits of commodity pools and their CTAs?

14. The leverage of collective investment vehicles is currently a focus of several financial regulators and certain legislators. In the case of very large pools, would the use of partially-funded accounts have any systemic risk implications, particularly where a pool's "assets" were over-allocated among a large number of CTAs and FCMs?

15. (a) Would the absence of actual funds information have any impact on a CTA's or an FCM's ability to properly gauge a pool's, or other large customer's, tolerance for risk?

    (b) Would the lack of actual funds information have any adverse impact upon an FCM's ability to know its customer? Please explain.

If you have any questions concerning the issues raised in this letter, please contact David P. Van Wagner at (202) 254-8955.

Sincerely,

David P. Van Wagner

David P. Van Wagner
Special Counsel

NATIONAL FUTURES ASSOCIATION
200 W. MADISON ST. • CHICAGO, IL • 60606-3447 • (312) 781-1300

August 24, 1994

David P. Van Wagner, Esq.
Special Counsel
Division of Trading and Markets
Commodity Futures Trading Commission
2033 K Street, N.W.
Washington, D.C. 20581

Re: Proposed National Futures Association Compliance Rule 2-34; Nominal Account Size

Dear Mr. Van Wagner:

This is in response to your letter posing a number of questions about NFA's proposed Interpretive Notice regarding the presentation of past performance and proposed NFA Compliance Rule 2-34. As you know, the presentation of past performance information for partially-funded accounts has long been a source of heated debate between the futures industry and the Commission. NFA agrees with the Commission's views, as stated both in your letter and in the Commission's various pronouncements on this issue over the years, that partial funding of accounts raises sales practice, disclosure and financial responsibility issues. Essentially, the Commission has attempted to deal with these issues by regulating how CPOs and CTAs calculate their rate of return ("ROR"). By stretching the regulations regarding calculations of ROR to deal with sales practice, disclosure, and financial responsibility, the Commission has attacked the right problems with the wrong tools. As a result, these issues have not been adequately addressed and the calculation of ROR is unnecessarily distorted.

Past performance presentation is merely a historical reflection of the trading that has occurred. By definition, at the time past performance is reported, a partially-funded account has already been opened and traded, the customer and CTA have agreed on an account size for trading, the account has been traded at that level, and less than 100% of the account size has been deposited with the FCM. For example, if the agreed upon account size was $100,000, the CTA put that client account on its allocation schedule, portfolio schedule, and so on with all his other $100,000 accounts, without any distinction for funds on deposit, and they were traded the same. While the client might have deposited only $20,000 in actual funds, the latter number is not relevant to the trading that was done. Computing the trading that was done on the $20,000 of actual funds will, if profitable, result in grossly overstated returns which do not reflect the terms on which the trading was done.

This sort of "gerry-rigged" approach also does not deal effectively with customer protection issues. For example, currently the requirement to provide customers solicited to open partially-funded accounts with specific enhanced disclosures depends entirely on which ROR calculation method, among the several possibilities currently available under CFTC Advisory 93-13 ("Advisory 93-13"),[1] the CTA chooses to use in its disclosure document. If the CTA opts to calculate past performance pursuant to the "actual funds" method, customers may not receive any enhanced disclosures; if the CTA shows past performance through "the fully-funded subset" method, the customer must be provided with additional disclosures.[2] There is no sound regulatory rationale for providing some customers with the additional disclosures and not others. Under NFA's proposal, all CTA customers solicited to open partially-funded accounts would be protected through additional disclosure requirements. Similarly, the current requirements allow CTAs to choose with the benefit of hindsight whichever method for disclosing past performance of partially-funded accounts is most flattering; create the potential for multiple, confusing, and inconsistent performance tables; and do not ensure that FCMs will be informed when an account is partially-funded.

NFA has attempted to bring a fresh perspective to the issues related to partially-funded accounts: issues which, frankly, have consumed far too much of the Commission's and the industry's time and energy over the last seven years. We have, in our view, addressed each of the concerns which the Commission has raised through compliance rules and interpretive notices tailored to meet those specific concerns.

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[1] 58 Fed. Reg. 8226 (February 12, 1993).

[2] NFA has heard that Commission staff may have taken the position that all partially-funded accounts must receive the disclosure mandated by Section V of Commission Advisory 93-13. However, any such interpretation has not been widely publicized, is not generally known in the industry, has not been the subject of a formal rule-making proceeding, and conflicts with the clear language of Advisory 93-13. For the purposes of this letter, we are assuming that the clear language of Advisory 93-13 has not been altered.

NFA

We look forward to discussing this approach with the Commission and welcome any refinements or comments which the Commission may offer. In that spirit we submit the following responses to your questions.

QUESTION 1:

Proposed new Compliance Rule 2-34(a)(1) refers to the amount of "funds" that a customer agrees to commit to a CTA's management, while section (b) of the Rule refers to the amount of "assets" that a member CPO allocates among CTAs "in such a way that the total committed is greater than the total assets of the pool." Please confirm our understanding that in this context "funds" and "assets" are both synonymous with "nominal account size" as described in Advisory 93-13.

ANSWER:

Your understanding is correct. The phrases "amount of funds the client agrees to commit to the CTA's management" and "assets [allocated] among CTAs in such a way that the total committed is greater than the total assets of the pool" as used in C.R. 2-34 both describe "nominal account size" and are synonymous with that term as it is defined in Advisory 93-13.

QUESTION 2:

Under the notional funds method, the amount of the "commitment" to the CTA's program is based on an amount specified in the customer agreement. Please address whether, under the NFA proposal, a customer would be required to have any particular amount of tangible financial resources to support or fund the amount of the commitment.

ANSWER:

This question really raises creditworthiness concerns that are unrelated to how performance is presented. Although NFA's proposal does not require a customer to have any particular amount of tangible financial resources to support or fund the amount of the commitment, nothing in NFA's proposal will affect the FCM's ability or its incentive to check on the creditworthiness of the account. In fact, C.R. 2-34 strengthens and clarifies the existing regulatory requirement that CTAs must report the amount of funds committed to trading to the FCM if an account is partially-funded. Under Advisory 93-13, the CTA is required to report the nominal account size to the FCM only on an exception basis (i.e., for any account that is not fully-funded). Therefore, if a CTA fails to do so, the FCM will be completely unaware that it is carrying a partially-funded account. By contrast, C.R. 2-34(a) requires the CTA to provide the FCM with a copy of the agreement -- which includes the amount committed to trading -- for <u>all</u> managed accounts. In other words, under NFA's proposal an FCM will expect to receive an agreement from all managed accounts, ensuring that the FCM will be on notice of any partially-funded accounts.

Furthermore, nothing in NFA's proposal changes the requirement under NFA Compliance Rule 2-30 to obtain financial and other information from the customer to enable the person soliciting the account to "know the customer." In addition, it could be a violation of NFA Compliance Rule 2-4 for a CTA to encourage a customer to open an account at a level that is inappropriate in view of the customer's net worth, income, and investment experience.

Customers with partially-funded managed accounts do not face any greater risk or create any greater risk for the FCM than customers who make their own trading decisions and do not keep free credit balances in their accounts. These risks are already adequately controlled by the margin requirements, and there is no basis for treating partially-funded accounts differently and requiring some particular amount of "tangible financial resources" (beyond the funds required for margin purposes).

<u>QUESTION 3</u>:

Please explain how proposed Rule 2-34's use of the term "amount committed" would relate to its common use in a financial accounting context.

<u>ANSWER</u>:

We are not aware that the term "amount committed" has a common use in a financial accounting context. For purposes of C.R. 2-34, the term "amount committed" is synonymous with nominal account size and means the account size which the client has directed the CTA to use in making trading decisions.

QUESTION 4:

The Association for Investment Management and Research ("AIMR") requires rates of returns ("RORs") to be computed on an unleveraged basis; that is, in the case of a security purchased on margin, the ROR would be based upon the total value of the security. In the case of derivatives, the comparable amount would appear to be the value of the securities or cash commodity from which the derivative is derived. How does NFA's proposed use of the notional funds method compare to the AIMR standard?

ANSWER:

NFA's proposal is actually much more consistent with the AIMR approach than the Commission's current requirements. Indeed, one of the Special Committee's primary goals was to pattern disclosure requirements in the futures industry as closely as possible on the AIMR standards. As you pointed out in your letter, AIMR generally requires that RORs be calculated on an unleveraged basis, and, therefore, in the case of a security purchased on margin, ROR would be computed using the total value of the security for determining the equity on which the computation is made.

However, in the case of many derivatives, and specifically in the case of futures, AIMR recognizes these instruments are inherently leveraged. Because the margin deposited by a client, which may vary from FCM to FCM, represents only a good faith deposit ensuring ultimate performance by the customer, AIMR recognizes that the margin amount has no particular relevance for performance presentation purposes. Likewise, because the client does not own the commodity underlying the futures contract, but merely the right to buy or sell it, the underlying value of the commodity is also not the appropriate amount to use in calculating ROR.

AIMR has specifically addressed the use of partially-funded futures accounts managed by professional advisors, and its approach is completely consistent with NFA's proposal. In Example 6 in Appendix D of AIMR's 1993 publication titled Performance Presentation Standards, AIMR uses an example of a notionally funded futures account. AIMR stated "that the returns must be calculated on the basis of the amount of assets allocated to the manager for investment (as opposed to only the amount deposited into the account for margin)."[3] AIMR further requires that the allocated amount "be verifiable on the basis of the client agreement with the manager."[4] Thus, for presentation purposes, AIMR requires ROR to be computed based on beginning net equity inclusive of any "notional" capital, just as NFA's proposal would require. AIMR's and NFA's approach are contrasted with the Commission's approach, which currently allows CTAs to calculate ROR based on the amount of funds on deposit with the FCM.

QUESTION 5:

Under the proposed notional funds method, there appears to be no explicit requirement for a fully-funded subset, as specified in Commission Advisory 93-13. Please explain how the proposal would address a situation in which the maximum percentage funding level by any retail customer of a CTA was 50% of the nominal account size, so that the CTA had no fully-funded retail accounts.

ANSWER:

Our proposal does not require that any accounts be fully-funded. However, neither does Advisory 93-13. Under that advisory, fully-funded accounts are required only if the fully-funded subset method of calculating ROR is used. CTAs which use the actual funds method of calculating ROR may well have no fully-funded accounts.

The rationale behind the Commission's requirement that a CTA have a certain number of fully-funded accounts before it can use the fully-funded subset method of calculating ROR is to ensure that there will be a

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[3] AIMR Performance Presentation Standards, (1993), pg. 56.

[4] Id. at 57.

benchmark for comparison purposes. Under NFA's proposal, the benchmark which would be used is all similarly situated accounts. Thus, all accounts with the same nominal account size which utilize the same trading program should receive the same trades, and all accounts in the same trading program should have substantially similar RORs.

QUESTION 6:

In the hypothetical situation from question 5 above, assuming a maximum of 50% funding for any account, does NFA believe it would be misleading for a CTA to claim it had funds under management based upon nominal account sizes?

ANSWER:

In our view, it is not misleading for a CTA to equate the amount of funds under management with the amount committed to trading since that is the amount of funds which clients have chosen to commit to the CTA's management. Of course, any statement -- even a statement which would not be misleading in and of itself -- may become misleading based on the way it is presented, including the context in which it is made. However, CFTC Regulations 4.21(h) and 4.31(g) and NFA Compliance Rule 2-29 provide adequate protection against the misuse of information concerning the amount of funds under management.

QUESTION 7:

In its submission, NFA indicates that the use of notional funds would require some special care to ensure that retail customers fully understand all the ramifications of such accounts. NFA does not appear to make explicit what disclosures would be required. Please compare the NFA proposal to the requirements of Advisory 93-13, indicating exactly which would be retained and which would be deleted, and include an explanation for the deletion of any requirement. For example, please compare the respective requirements of the proposal and Advisory 93-13 with regard to: (a) the amount of actual funds with which the customer intends to fund the account, (b) the actual funds under management, (c) the fees as a percentage of actual funds, and (d) the need for a fully-funded subset.

ANSWER:

NFA realizes that sales practice abuses can occur whenever a customer is not given adequate information to fully understand the nature of his or her investment. The use of nominal accounts as an investment vehicle is no exception. Therefore, NFA believes that the customer should be fully informed of the difference between a partially-funded and a fully-funded account before deciding to invest through a partially-funded account. Furthermore, the availability of this information to the customer ought not to depend on how the CTA has chosen to reflect past performance in its disclosure document. Unfortunately, this disclosure is not currently required if the actual funds method of reporting ROR is used. Under NFA's proposal, on the other hand, the CTA must make relevant disclosures to <u>all</u> customers who use notionally funded accounts.

Proposed C.R. 2-34 was written to provide all of the relevant disclosures currently required by the Special Disclosure for Notionally-Funded Accounts ("Special Disclosure") found in paragraph V of Advisory 93-13 and the CTA/Client Agreement found in paragraph VIII of that advisory. Both the Special Disclosure and the CTA/Client Agreement are required if, and only if, the CTA opts to report ROR using the fully-funded subset method. The agreement required by Proposed C.R. 2-34(a), on the other hand, is required for <u>all</u> accounts directed by a CTA, regardless of the level of funding or the CTA's willingness to manage partially-funded accounts. The disclosures required by C.R. 2-34(b) are required for <u>all</u> partially-funded accounts.

C.R. 2-34 does make explicit the information that has to be included in agreements for all managed accounts and the disclosures that have to be made to clients with partially-funded accounts. Unlike the Special Disclosure, however, it does not dictate the language to be used in making those disclosures. By not dictating particular language, the CTA or CPO has more flexibility to ensure that the disclosures are appropriate for a particular trading program or pool. Of course, the CTA or CPO is still required by Commission Regulations 4.21(h) and 4.31(g) and NFA Compliance Rule 2-29 to make all necessary disclosures and to ensure that its disclosure document and other promotional materials are not misleading.

As the Commission has recognized in its recent rule amendments to its disclosure requirements, lengthy or complicated disclosures can be counterproductive by discouraging the customer from reading them. Therefore, NFA has attempted in its proposal to eliminate any disclosures of marginal value. However, since the intent of C.R. 2-34 is to include all relevant disclosures from Advisory 93-13, NFA is certainly willing to add additional language to the disclosures required by C.R. 2-34 if the Commission believes that language is necessary to provide the customer with adequate information about partially-funded accounts.

The following is a side-by-side comparison of the disclosure requirements of Advisory 93-13 and C.R. 2-34.

CFTC REQUIREMENTS	NFA REQUIREMENTS	COMMENTS
".... The agreement must specify: a. the name of the CTA's trading program in which the customer is participating...." [CTA/Client Agreement, Section VIII of the Advisory]	"[The agreement must state:] (2) the name or description of the trading program the client is participating in...." [C.R. 2-34(a)]	The CFTC's CTA\Client Agreement is only required for partially-funded accounts, while the agreement required by NFA C.R. 2-34(a) is required for all managed accounts.
".... The agreement must specify: ... b. the Nominal Account Size, including how profits, losses and withdrawals/additions of Actual Funds and trading would affect or be related to the Nominal Account Size...." [CTA/Client Agreement, Section VIII of the Advisory] "1. Although your gains and losses ... measured in dollars will be the same, they will be greater when expressed as a percentage of account equity." [Special Disclosure, Section V of the Advisory]	"[The agreement must state:] (1) the amount of funds the client agrees to commit to the CTA's management....[and] (4) how profits and losses will affect the amount committed to trading." [C.R. 2-34(a)]	Although the disclosure required under C.R. 2-34(a)(4) is not identical to the disclosure regarding profits and losses in section 1 of the Special Disclosure, it should highlight to the customer that profits and losses are calculated based on the amount committed rather than on actual funds in a partially-funded account. In addition, the preamble to the Special Disclosure directs the client to ask the customer how much money should be deposited to fully fund the account. Since the fully-funded amount is always specified in the agreement, NFA sees no need for the client to ask the CTA what that amount would be.

".... The agreement must specify: ... c. how and to what extent (as a percentage of the account's Nominal Account Size) the account will be funded with Actual Funds." [CTA/Client Agreement, Section VIII of the Advisory]	"[The agreement must state:] (3) whether the client intends to deposit or maintain with the FCM an amount equal to the amount committed...." [C.R. 2-34(a)]	C.R. 2-34(a)(3) does not require the agreement to contain the level of actual funding as a percentage of the nominal account size. Obviously, however, the funding level can be easily calculated by both the customer and the FCM since they will both know the amount committed to trading (as listed in the agreement) and the amount of actual funds on deposit at any particular point in time based on the account statements sent by the FCM to the client.
"You should request your commodity trading advisor to advise you of the amount of cash or other assets (Actual Funds) which should be deposited to the advisor's trading program for your account to be considered "Fully-Funded". This is the amount upon which the commodity trading advisor will determine the number of contracts traded in your account and should be an amount sufficient to make it unlikely that any further cash deposits would be required from you over the course of your participation in the commodity trading advisor's program." [Special Disclosure, Section V of the Advisory]	"[The agreement must state:] (1) the amount of funds the client agrees to commit to the CTA's management...." [C.R. 2-34(a)]	Since the fully-funded amount is always specified in the agreement, NFA sees no need for the client to ask the CTA what that amount would be.

"You are reminded that the account size you have agreed to in writing (the "nominal" or "notional" account size) is not the maximum possible loss that your account may experience." [Special Disclosure, Section V of the Advisory]	"Any Member who violates any of CFTC Regulations ... 4.16 through 4.41 shall be deemed to have violated an NFA Requirement...." [Compliance Rule 2-13] "Any Member or Associate who violates ... CFTC Regulation ... 1.55 ... shall be deemed to have violated an NFA requirement. ...." [Compliance Rule 2-26] "(a) Each Member or Associate shall, in accordance with the provisions of this Rule, obtain information about its futures customers who are individuals and provide such customers with disclosure of the risks of futures trading.... "d) The risk disclosure to be provided to the customer shall include at least the following: (1) the Risk Disclosure Statement required by CFTC Regulation 1.55, if the Member is required by that Regulation to provide it; (2) the Disclosure Document required by CFTC Regulation 3.41, if the Member is required by that Regulation to provide it; ..." [Compliance Rule 2-30]	NFA believes that the disclosures required by CFTC Regulations 1.55 and 4.31(a)(8) already make this point. In addition, the disclosures required by C.R. 2-34(b)(4) concerning the effect of partial funding on the frequency and amount of margin calls (discussed below) should remind the client that the nominal account size is not the maximum loss the account may experience. NFA also notes that, if the special disclosure required by Advisory 93-13 were really necessary, it would be equally necessary for all partially-funded accounts, regardless of the method the CTA uses to calculate ROR, and for fully-funded accounts. The fact that the Advisory requires it only for partially-funded accounts and only then if the CTA uses the fully-funded subset method of calculating ROR indicates that this is not of great concern to the CFTC. Furthermore, NFA believes that the disclosure required by the Commission actually creates a false sense of security by leading customers to believe that by fully-funding their accounts they can limit their risk to that amount.

"You should consult the account statements received from your futures commission merchant in order to determine the actual activity in your account, including profits, losses and current cash equity balance."	No analogous provision.	NFA does not believe it is necessary to inform a client that he should use common sense. Again, there is no reason to distinguish between clients with partially-funded accounts based solely on the way ROR is calculated.
"1. Although your ... fees and commissions measured in dollars will be the same, they will be greater when expressed as a percentage of net equity." [Special Disclosure, Section V of the Advisory] "ii. Asset based costs/fees should be denominated as a percentage of the amount of Actual Funds to be collected from a prospective customer at the inception of the account, although use of the percentage of the Nominal Account Size may also be disclosed. [Section X of the Advisory]	"[The CTA or CPO must provide the client or participant in writing with:] (1) a clear statement of how the management fees will be computed in relation to the amount of funds committed to trading; (2) for CTAs, a statement that commissions and fees will be a greater percentage of the funds on deposit than if the client deposited or maintained with the FCM the entire amount committed; (3) for CPOs, a statement that commissions and fees will be a greater percentage of the assets of the pool than if the pool assets were allocated differently ...." [C.R. 2-34(b)]	A CTA is required to provide a client with the CFTC's Special Disclosure only if the fully-funded subset method of calculating ROR is used, while NFA C.R. 2-34(b) requires disclosures to be made to all clients with partially-funded accounts. C.R. 2-34(b)(1) and (3) requires a CPO of a pool which allocates more than its total assets to trading to disclose to pool participants the effect of that practice on fees. The CFTC has no analogous requirement. NFA does not believe that asset based costs and fees should be given as a percentage of actual funds since actual funds on deposit is an arbitrary amount based on the client's own cash-management policies and has little or nothing to do with the way the account is traded. In any event, a client will have sufficient information to calculate fees as a percentage of actual funds if the client desires to do so.

"2. You may receive more frequent and larger margin calls." [Special Disclosure, Section V of the Advisory]	"(4) [The CTA must inform the client in writing of] the effect of partial funding levels on the frequency and amount of margin calls." [C.R. 2-34(b)]	Again, the CFTC's Special Disclosure is required only if the fully-funded subset method of calculating ROR is used, while NFA C.R. 2-34(b) requires these disclosures to be made to all clients with partially-funded accounts.
"3. The disclosures which accompany the performance table may be used to convert the rates-of return ("RORs") in the performance table to the corresponding RORs for particular partial funding levels." [Special Disclosure, Section V of the Advisory]	No analogous provision.	NFA does not believe that there are different RORs for different funding levels. The relevant inquiry is the amount committed to trading, not the amount of funds deposited for margin purposes. Nonetheless, we note that the overall impact of the disclosure required by C.R. 2-34(b) highlights the fact that calculations based on actual funds would be different from calculations based on the amount committed to trading.
"i. When referring to funds under management, the amount of Actual Funds under management should always be disclosed. If also referring to the amount of funds under management inclusive of Notional Funds, such amount should be referred to as 'including Notional Funds'." [Section X of the Advisory]	No analogous provision.	Practically speaking, the amount of funds under management is the amount which clients have determined to commit to the CTA, not the amount of actual funds. NFA is not aware of any reason why a client or potential client would need to know the amount of actual funds under management.

Finally, you asked us to discuss the need for a fully-funded subset. Under NFA's proposal there is no need for a fully-funded subset. Since ROR is based on the amount of funds committed to trading rather than on actual funds, the ROR generated under NFA's proposal and an ROR based on a fully-funded subset would be substantially the same.

QUESTION 8:

Please address disclosure and other issues presented by a retail customer participating in a CTA's program on a partially-funded basis, as compared to a fully-funded basis.

ANSWER:

NFA recognizes that abuses stemming from inadequate disclosure can occur when promoting partially-funded accounts, just as they can occur in other situations. However, "interpreting" regulations regarding the calculation of ROR not only fails to prevent these disclosure abuses, but also distorts ROR in a way that, in and of itself, may be misleading to potential clients. The requirements of C.R. 2-34 are a much more effective way to deal with such sales practice concerns. The disclosures which must be given to non-QEP customers are listed in C.R. 2-34(b) and discussed in detail in the answer to Question 7, above.[5] In addition, NFA Compliance Rule 2-30 will continue to apply to individuals and will give the person soliciting the account -- be it the CTA, FCM, or IB -- a basis for judging whether the client should be given additional disclosures, which could include the disclosure that trading on a partially-funded basis may be too risky for that customer. Furthermore, by requiring the CTA to enter into an agreement with each managed account customer -- regardless of whether the customer intends to partially or fully fund his account -- and to include the amount committed in the agreement, C.R. 2-34(a) ensures that <u>all</u> managed

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[5] Even though there is no generally accepted definition of the term "retail customer," it is generally understood that the term is not necessarily synonymous with "unsophisticated customer," nor does it necessarily exclude all qualified eligible participants ("QEPs") as defined in CFTC Regulation 4.7. C.R. 2-34 is intended to protect unsophisticated customers with limited means from abusive sales practices and aggressive marketing of notional funds programs which they may not understand. Although we realize that many non-QEPs may be sophisticated customers of substantial means, some objective and preferably established test was needed to determine who should receive the disclosures required by C.R. 2-34(b). Therefore, C.R. 2-23(b) applies to all customers except QEPs.

account customers, as well as the FCM, will know the amount of funds the CTA is basing its trading decisions on.

QUESTION 9:

In its proposal, the NFA states that sophisticated customers often maintain only minimum amounts of margin in their commodity interest trading accounts and that as a result the ROR computation method required by the Commission, referred to as the "actual funds" method in Advisory 93-13, yields distorted results for such accounts. The NFA asserts that its proposed notional funds method would be a better means of presenting the performance of the accounts of such sophisticated customers than the actual funds method. However, customers thought to be "sophisticated" generally are Regulation 4.7 qualified eligible participants ("QEPs"). CTAs trading accounts of QEPs are not subject to the specific requirements of Commission rules in presenting performance to such persons. Please explain why NFA would mandate any particular reporting standard for such accounts.

ANSWER:

In our view, this question misses the point. NFA's proposal does not regulate disclosure to QEPs. However, we recognize that QEP performance must be reported to non-QEPs. The use of the actual funds method for computing RORs in partially-funded accounts (QEP or otherwise) distorts the RORs reported to non-QEPs.

QUESTION 10:

Under the actual funds method, assuming a constant level of futures trading and profits and losses experienced in accounts traded with the same number of contracts, the month-to-month percentage changes in account equity would be proportionately larger for accounts funded with less margin funds. The amount of margin funds in an account is a function of how much money the customer has deposited, plus or minus profits and losses. The amount of such actual funds is readily subject to verification. How would the notional account size be verified at any particular point in time and over time?

ANSWER:

The agreement must state the amount committed to trading when the agreement is entered into (or modified) and must describe how profits and losses will affect that amount. Using this information, notional account size on any particular day or over a period of time should be readily calculable from the daily profit and loss figures for the account.

Under Advisory 93-13, the notional account size in many accounts cannot be verified. Although the CTA is required to report the nominal account size to the FCM on an exception basis (i.e., for any account that is not fully-funded), a customer is not required to agree in writing to the nominal account size unless the CTA uses the fully-funded subset method of computing ROR. Therefore, a CTA could conceivably conceal the fact that an account is only partially-funded by not informing the FCM to the contrary, and there would be no document in the file to prove otherwise. Under NFA's proposal, it will be much easier to verify the amount committed by the customer because the customer will have to agree to it in writing, and NFA will be able to verify whether the account is traded similarly to and has similar results as all other accounts which, according to the written agreements, utilize the same trading program.

QUESTION 11:

It is commonly assumed that customers prefer low levels of fluctuation of return and are attracted to low percentage management fees. In this connection, if NFA were to establish no requirement for a fully-funded subset, what would prevent a CTA from establishing relatively high nominal account sizes to give the appearance of a smooth rate of return and a low percentage fee?

ANSWER:

Nothing in NFA's rule proposal allows a CTA to mask volatility or fees. In fact, that is what C.R. 2-34 is designed to prevent. Furthermore, under NFA's proposed rule a CTA simply does not have the authority to create "relatively high nominal account sizes." The nominal account size is determined by the customer who has to sign the agreement, not by the CTA. It is ludicrous to suggest that customers would conspire with the CTA to mask the CTA's future volatility or fees. Moreover, a CTA which uses the actual funding method for presenting past performance is not required to give _any_ disclosure and could effectively mask fees under the current rules.

In any event, NFA questions the assumption that a CTA would choose to establish artificially high nominal account sizes in order to mask volatility and create the impression that the CTA's fees are low. In NFA's experience, we have seen far more abuses involving inflated RORs than artificially depressed volatility or fees. The actual funds method feeds these abuses by inflating ROR for marginally profitable, as well as highly successful, CTAs. NFA's method will not.

Furthermore, unlike the CFTC's alternative methods of calculating ROR, NFA's proposal will not allow a CTA to pick and choose the method which is most flattering to it. By mandating the one method which most accurately reflects true performance, NFA's proposal improves the overall quality of the performance information which must be provided to customers and potential customers.

QUESTION 12:

In comparison to the actual funds method, how well would the notional funds method convey the impact of materially different levels of leverage among various customers' accounts, between accounts of varying degrees of leverage and from one historical period to another?

ANSWER:

Again, NFA does not accept the assumption, inherent in the question, that the actual funds method measures volatility and conveys the impact of different levels of leverage better than the method proposed by NFA. Although the actual funds method of calculating ROR does show bigger ups and downs, it does not present an accurate picture of volatility. Instead, the actual funds method of calculating ROR presents a distorted picture of volatility by treating a $100,000 account funded at 10% and a fully-funded $10,000 account as if they were the same; exaggerates profits and losses; creates widely divergent RORs for similarly traded accounts based solely on the clients' different cash management policies; and ignores the practical reality that both the CTA and the client consider the account size to be equivalent to the amount committed to trading rather than to the amount deposited for margin. NFA's method presents a more accurate picture of volatility and has none of the other limitations inherent in the actual funds method.

NFA does not believe that the performance information in the disclosure document should reflect different RORs for accounts in the same trading program simply because of their different funding levels. However, if the Commission is concerned that the customer will not have sufficient information concerning the effect of partial-funding on leverage and volatility, NFA is willing to add additional disclosure requirements to C.R. 2-34.

QUESTION 13(a):

Under the proposed notional funds method, it appears that a CTA would not be required to obtain from its customers the amount of actual funds allocated to the trading program, and that the CTA, therefore, may only be aware of the trading level selected by the customer. Without the disclosure of the amount of actual funds allocated to the CTA, which is presently required by Advisory 93-13, it would seem that customers who are pools could "allocate" to their CTAs many times the amount of actual funds in their possession without the knowledge of the CTAs. That is, the traders of the pool's assets would be unaware of the true amount they were leveraging the pool's assets because they would not know the actual amount of the assets. Please address the reasons for permitting CPOs to allocate more assets than are contained in a pool and what disclosures would be made to CTAs.

ANSWER:

A CTA will continue to know the amount of actual funds in the client's account because the CTA receives copies of the account statements. [See CFTC Regulation 1.33(d).] However, a CTA does not need to know, and does not use, this information. A CTA bases its trading decisions on the amount of money committed to trading, not on the amount of actual funds in the account. This is the way it works now -- regardless of which method the CTA uses to compute ROR -- and the way it will continue to work.

Pool participants have chosen to invest in a pool based, in part, on how the CPO intends to allocate pool assets. Provided that the CPO has adequately disclosed his intentions and the attendant risks, we see no reason to preclude the CPO from following its stated intentions.

Neither the Commission's current rules nor NFA's proposal prohibits CPOs from allocating more assets to trading than the pool has in its possession. NFA's proposal merely recognizes the current practice and mandates the CPO to provide disclosure to the pool participants to ensure that they understand the effect of this practice. NFA's proposal does not mandate any particular disclosures to the CTA since the CTA is responsible only for trading the funds allocated to it and is not responsible for ensuring the overall integrity of the pool.

QUESTION 13(b):

Has the NFA encountered this practice in its audits of commodity pools and their CTAs?

ANSWER:

Yes, NFA audits have revealed that, on occasion, the sum of a pool's assets allocated to CTAs for trading is greater than the pool's total assets. However, the only time this practice has been troublesome has been when there was not been enough disclosure to pool participants. NFA's proposal deals with this lack of disclosure by increasing the disclosure requirements under C.R. 2-34(b). Aside from the requirements of

CFTC Regulation 4.21(h), which requires a CPO to provide a pool participant with all material information, CPOs are not required to make any special disclosures to participants in a pool which commits more than its total assets to trading. Advisory 93-13 requires disclosure only by a CTA and only if the CTA uses the fully-funded subset. C.R. 2-34(b), on the other hand, requires a CPO which commits more than the pool's total assets to trading to provide all participants in that pool with certain disclosures concerning the effect of partial funding on commissions and fees.

QUESTION 14:

The leverage of collective investment vehicles is currently a focus of several financial regulators and certain legislators. In the case of very large pools, would the use of partially-funded accounts have any systemic risk implications, particularly where a pool's "assets" were over-allocated among a large number of CTAs and FCMs?

ANSWER:

The continued use of partially-funded accounts by large pools does not create any systemic risks that are not already being controlled through exchange and FCM margin requirements. Moreover, to the extent such risks exist, they are not created by NFA's rule proposal.

QUESTION 15(a):

Would the absence of actual funds information have any impact on a CTA's or an FCM's ability to properly gauge a pool's, or other large customer's, tolerance for risk?

ANSWER:

There is no "absence of actual funds information" for either the FCM or the CTA. As explained in the answer to question 13(a), under NFA's proposal both the FCM and the CTA have actual funds information. NFA's proposal does not lessen the amount of information available to either the FCM or the CTA. In addition to actual funds information, the CTA will know the amount committed to trading and, if it solicited the account, the information required by NFA Compliance Rule 2-30. The FCM will know the amount committed to trading and will presumably have conducted a credit check on the customer. In fact, NFA's proposal improves the flow of information to the FCM to ensure that it will be provided with accurate information on the amount committed to trading. While Advisory 93-13 requires the CTA to provide this information to the FCM, Advisory 93-13 does not require the CTA to obtain a written agreement from the customer as to this amount unless the CTA uses the fully-funded subset. Since NFA's proposal requires <u>all</u> managed account owners to sign a written agreement containing the amount committed to trading, it will be harder for CTAs to "hide" nominal account sizes from their FCMs by simply not reporting that a particular account is not fully-funded.

Furthermore, to the extent that this question is addressed to systemic or particular risk, it misses the point. As previously mentioned, creditworthiness and sales practice issues cannot be resolved by regulating presentation of past performance information. Although NFA's proposal eliminates the need to include actual funds information in the disclosure document for purposes of calculating or reporting ROR, it does not reduce the information that is available to the client, the CTA, or the FCM in regard to the client's account.

<u>QUESTION 15(b)</u>:

Would the absence of actual funds information have any adverse impact on an FCM's ability to know its customer? Please explain.

<u>ANSWER</u>:

As noted above, the FCM will have actual funds information since the FCM carries the funds. The FCM will also have information on the amount committed to trading and the results of the credit check done on the customer. NFA's proposal increases the information available to the FCM and has absolutely no adverse impact upon an FCM's ability to know its customer or control systemic risk.

If you have any questions concerning this letter, please contact me (312-781-1390) or Kathryn Camp (312-781-1393) of my staff. We look forward to a quick response to and approval of NFA's proposal.

Very truly yours,

Daniel J. Roth
General Counsel

(e:\kpc\nominal.ltr)

cc: Andrea M. Corcoran, Esq.
Susan C. Ervin, Esq.

NATIONAL FUTURES ASSOCIATION
200 W. MADISON ST. • CHICAGO, IL • 60606-3447 • (312) 781-1300

September 1, 1994

Ms. Jean A. Webb
Secretariat
Commodity Futures Trading Commission
2033 K Street, N.W.
Washington, D.C. 20581

Re: National Futures Association: Proposed Amendments to NFA Compliance Rule 2-29 and Proposed Adoption of Interpretive Notice to NFA Compliance Rule 2-29

Dear Ms. Webb:

By letter dated March 15, 1994, National Futures Association ("NFA") submitted to the Commodity Futures Trading Commission ("CFTC" or "Commission") for its review and approval proposed amendments to NFA Compliance Rules 2-13 and 2-29 and proposed adoption of NFA Compliance Rule 2-34 and certain Interpretive Notices, all of which were based on recommendations from NFA's Special Committee for the Review of CPO/CTA Disclosure Issues and approved by NFA's Board of Directors.

NFA hereby substitutes the text of NFA Compliance Rule 2-29 contained in the March 15, 1994 submission letter with the proposed text set forth herein. NFA also submits for the Commission's approval an Interpretive Notice to NFA Compliance Rule 2-29 relating to the use of promotional material containing hypothetical performance results. The proposed amendments to NFA Compliance Rule 2-29 and the proposed Interpretive Notice were approved by NFA's Board of Directors on August 18, 1994.

NFA also wishes the Commission to view this submission letter as NFA's comments in response to a Federal Register release by the Commission on June 15, 1994 concerning NFA's proposed restriction on the use of hypothetical results in promotional material.[1]

PROPOSED AMENDMENTS TO NFA COMPLIANCE RULE 2-29

The proposed amendments to NFA Compliance Rule 2-29 are as follows (additions are underscored and deletions are bracketed):

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[1] 59 Fed. Reg. 30776 (1994).

COMPLIANCE RULES

* * *

Part 2 -- RULES GOVERNING THE BUSINESS CONDUCT OF MEMBERS REGISTERED WITH THE COMMISSION

* * *

Rule 2-29. COMMUNICATIONS WITH THE PUBLIC AND PROMOTIONAL MATERIAL.

* * *

(b) Content of Promotional Material.

No Member or Associate shall use any promotional material which:

(1) is likely to deceive the public; or

(2) contains any material misstatement of fact or which the Member or Associate knows omits a fact if the omission makes the promotional material misleading; or

(3) mentions the possibility of profit unless accompanied by an equally prominent statement of the risk of loss; or

[(4) includes a measurement or description of or makes any reference to hypothetical results which could have been achieved had a particular trading system been employed in the past unless accompanied by the statement prescribed in CFTC Rule 4.41(b)(1); or]

[(5)]<u>(4)</u> includes any reference to actual past trading profits without mentioning that past results are not necessarily indicative of future results; or

[(6)]<u>(5)</u> includes any specific numerical or statistical information about the past performance of any actual accounts (including rate of return) unless such information is and can be demonstrated to NFA to be representative of the actual performance for the same time period of all reasonably comparable accounts and, in the case of rate of return figures, unless such figures are calculated in a manner consistent with that required under CFTC Rule 4.21(a)(4)(ii)(F).

(c) Hypothetical Results.

(1) Any Member or Associate who uses promotional material which includes a measurement or description of or makes any reference to hypothetical performance results which could have been achieved had a particular trading system of the Member or Associate been employed in the past must include in the promotional material the following disclaimer prescribed by NFA's Board of Directors:

> HYPOTHETICAL PERFORMANCE RESULTS HAVE MANY INHERENT LIMITATIONS, SOME OF WHICH ARE DESCRIBED BELOW. AS A RESULT OF THESE LIMITATIONS, HYPOTHETICAL PERFORMANCE RESULTS HAVE LIMITED PREDICTIVE VALUE. IN FACT, THERE ARE FREQUENTLY SHARP DIFFERENCES BETWEEN HYPOTHETICAL PERFORMANCE RESULTS AND THE ACTUAL RESULTS SUBSEQUENTLY ACHIEVED BY ANY PARTICULAR TRADING PROGRAM.
>
> ONE OF THE LIMITATIONS OF HYPOTHETICAL PERFORMANCE RESULTS IS THAT THEY ARE GENERALLY PREPARED WITH THE BENEFIT OF HINDSIGHT. IN ADDITION, HYPOTHETICAL TRADING DOES NOT INVOLVE FINANCIAL RISK, AND NO HYPOTHETICAL TRADING RECORD CAN COMPLETELY ACCOUNT FOR THE IMPACT OF FINANCIAL RISK IN ACTUAL TRADING. FOR EXAMPLE, THE ABILITY TO WITHSTAND LOSSES OR TO ADHERE TO A PARTICULAR TRADING PROGRAM IN SPITE OF TRADING LOSSES ARE MATERIAL POINTS WHICH CAN ALSO ADVERSELY AFFECT ACTUAL TRADING RESULTS. THERE ARE NUMEROUS OTHER FACTORS RELATED TO THE MARKETS IN GENERAL OR TO THE IMPLEMENTATION OF ANY SPECIFIC TRADING PROGRAM WHICH CANNOT BE FULLY ACCOUNTED FOR IN THE PREPARATION OF HYPOTHETICAL PERFORMANCE RESULTS AND ALL OF WHICH CAN ADVERSELY AFFECT ACTUAL TRADING RESULTS.

If a Member or Associate has either less than one year experience in directing customer accounts or trading proprietary accounts, then the disclaimer must also contain the following statement:

(THE MEMBER) HAS HAD LITTLE OR NO EXPERIENCE IN TRADING ACTUAL ACCOUNTS FOR ITSELF OR FOR CUSTOMERS. BECAUSE THERE ARE NO ACTUAL TRADING RESULTS TO COMPARE TO THE HYPOTHETICAL PERFORMANCE RESULTS, CUSTOMERS SHOULD BE PARTICULARLY WARY OF PLACING UNDUE RELIANCE ON THESE HYPOTHETICAL PERFORMANCE RESULTS.

(2) Any Member or Associate who uses promotional material which includes a measurement or description of or makes any reference to hypothetical performance results which could have been achieved had a particular trading system of the Member or Associate been employed in the past must include in the promotional material comparable information regarding:

(i) past performance results of all customer accounts directed by the Member pursuant to a power of attorney over at least the last five years or over the entire performance history if less than five years; and

(ii) if the Member has less than one year experience in directing customer accounts, past performance results of his proprietary trading over at least the last five years or over the entire performance history if less than five years.

(3) Any Member or Associate utilizing promotional material containing hypothetical performance results must adhere to all the requirements contained in the Board's Interpretive Notice relating to this issue. [See Interpretive Notice at ¶ .]

(4) These restrictions on the use of hypothetical trading results shall not apply to promotional material directed exclusively to persons who meet the standards of a "Qualified Eligible Participant" under CFTC Rule 4.7.

[(c)] (d) **Statements of Opinion.**

* * *

[(d)] (e) **Written Supervisory Procedures.**

* * *

[(e)] <u>(f)</u> **Recordkeeping.**

* * *

[(f)] <u>(g)</u> **Filing with NFA.**

* * *

[(g)] <u>(h)</u> **Definition.**

* * *

<u>PROPOSED INTERPRETIVE NOTICE TO NFA COMPLIANCE RULE 2-29</u>

NFA COMPLIANCE RULE 2-29

INTERPRETIVE NOTICE RELATING TO THE USE OF PROMOTIONAL MATERIAL CONTAINING <u>HYPOTHETICAL PERFORMANCE RESULTS</u>

Over the years the use of hypothetical performance results has repeatedly produced highly misleading promotional material. By their very nature, such performance results have certain limitations. For example, hypothetical performance results do not represent actual trading and are generally designed with the benefit of hindsight which may under- or over-compensate for the impact of certain market factors, including lack of liquidity and price slippage. Furthermore, since hypothetical trading does not involve financial risk, no hypothetical performance results can completely account for the impact of certain factors associated with risk, including the ability of the customer or the advisor to withstand losses or to adhere to a particular trading program in the face of trading losses. Despite these limitations, there have been numerous instances in which Members in one form or another have attempted to induce customers to place undue reliance on hypothetical results. NFA's Business Conduct Committee has not hesitated to issue charges against Members engaging in such practices and will continue to pay close attention to advertising materials which display hypothetical results.

The use of hypothetical results has been the subject of regulatory scrutiny before. In 1981, the Commodity Futures Trading Commission ("CFTC" or "Commission") considered a total ban on the use of such results. Ultimately, the Commission determined to require CPOs and CTAs displaying hypothetical results to display the disclaimer set forth in CFTC Regulation 4.41. The Commission noted at the time that it might well impose sterner measures if the disclaimer proved ineffective at preventing abuses. NFA subsequently required all NFA Members and Associates to display Regulation 4.41's disclaimer in any promotional material which contains such results.

In NFA's experience, however, the use of the mandated disclaimer has not prevented recurring abuses in the presentation of hypothetical results. In some instances Members have touted dramatic hypothetical profits without revealing that their actual performance is much worse. This situation has been addressed by an amendment to NFA Compliance Rule 2-29(c)(2) which requires Members advertising hypothetical results to disclose their actual results as well. In other cases Members have effectively diminished the impact of the disclaimer by grossly over-emphasizing the significance of very dramatic hypothetical profits. For example, some Members have utilized promotional material which present hypothetical rates of return in large, bold face print while the disclaimer can be read only with a magnifying glass. In other advertising pieces the disclaimer is so far removed from the touted hypothetical profits that customers may never find it. There have also been instances in which Members or Associates have attempted to disguise hypothetical performance results as actual performance results.

Due to these problems, NFA's Board of Directors recently reviewed whether NFA Members and Associates should be permitted to utilize hypothetical performance results in promotional material. During this review, the Board considered a complete ban on the presentation of these results in promotional material due to its potentially abusive and misleading nature. However, in considering such a ban, the Board also recognized that in certain circumstances the presentation of hypothetical performance results in promotional material may have some limited utility. As a result, the Board decided to continue to allow Members and Associates to utilize promotional material containing hypothetical performance results under very stringent restrictions. Any Member or Associate utilizing such promotional material including, but not limited to, those soliciting for a managed account program or advertising to sell a particular trading program, newsletter or market letter, shall, at a minimum, adhere to the following requirements.

First, any Member or Associate utilizing promotional material which presents hypothetical performance results must provide to customers the disclaimer contained in NFA Compliance Rule 2-29(c)(1). The Board has expanded the required disclaimer to provide a more thorough discussion of the limitations of hypothetical results and of the dangers in placing reliance upon them. To prevent the over-emphasis of hypothetical performance results, the disclaimer must be displayed as prominently as the hypothetical results themselves. Generally, this would require that the disclaimer be printed in a type size at least as large as that used for the hypothetical results. Similarly, to avoid circumstances where hypothetical performance results are presented in one section of the promotional material with the disclaimer buried in another, the disclaimer must now immediately precede or follow the performance results. Whenever the Member or Associate has less than twelve months of actual results, the disclaimer must immediately precede the hypothetical performance results. Furthermore, if the promotional material contains several pages of hypothetical performance results, then the Member or Associate may need to include this disclaimer more than once in the material.

Second, any Member or Associate utilizing promotional material which presents hypothetical performance results must also describe in the promotional material all of the material assumptions that were made in preparing the hypothetical results. At a minimum, the description of material assumptions must cover points such as initial investment amount, reinvestment or distribution of profits, commission charges, management and incentive fees, and the method used to determine purchase or sale prices for each trade. Members must also make all material disclosures necessary to place the hypothetical results in their proper context, which in some instances may go well beyond the prescribed disclaimer. Furthermore, Members and Associates must calculate hypothetical performance results in a manner consistent with that required under the CFTC's Part 4 Regulations.

Third, when any Member or Associate utilizes promotional material which contains both hypothetical and actual performance results, then the actual results must be presented with at least the same prominence devoted to the hypothetical results. Both the hypothetical and actual performance results must be appropriately identified, separately formatted, discussed in an equally balanced manner and calculated pursuant to the same rate of return method. Furthermore, the promotional material must not contain any statement which places undue emphasis on the hypothetical performance results, for example, by discounting or downplaying the significance of any actual performance results.

The presentation of hypothetical performance results in promotional material is, of course, subject to all other NFA Requirements. Pursuant to NFA Compliance Rule 2-29(b)(1) and (2), the ultimate test of any promotional material is whether the overall impact of the material is misleading or likely to deceive the public. Although NFA has issued this Interpretive Notice, the Board recognizes that it cannot describe every manner in which promotional material containing hypothetical performance results may be misleading. The fact that an NFA Member or Associate has printed the disclaimer required pursuant to NFA Compliance Rule 2-29 and that the promotional material is in facial compliance with this Interpretive Notice does not ensure that material is not misleading.

Promotional material which contains hypothetical performance results will continue to be carefully scrutinized by NFA staff. Pursuant to NFA Compliance Rule 2-29(e), Members and Associates presenting hypothetical results in their promotional material must be able to demonstrate to NFA's satisfaction the validity of the presentation of the results. The greater the emphasis on dramatic hypothetical profits, the greater the Member's burden in demonstrating the validity of the presentation.

EXPLANATION OF PROPOSED AMENDMENTS AND INTERPRETIVE NOTICE

In its March 15, 1994 letter to the Commission, NFA submitted a series of proposals from the Special Committee for the Review of CPO/CTA Disclosure Issues ("Special Committee"), including one which would limit the use of hypothetical performance results. Specifically, the proposed amendments to NFA Compliance Rule 2-29(c) provide that no NFA Member -- regardless of category -- may use promotional material referring to hypothetical performance results unless the material also provides comparable information regarding the Member's actual trading results for at least a one year period and the statement prescribed in CFTC Regulation 4.41(b)(1).

Although those amendments are only a small part of the Special Committee's overall proposals, the amendments have generated some controversy among various NFA Members. At the Board's direction, the Chairman of the Special Committee requested the formation of a Discussion Group to explore alternative approaches to hypothetical performance issues. During several meetings, this Discussion Group reviewed the Board's regulatory objectives of the submitted amendments and subsequently decided that those proposed amendments to Compliance Rule 2-29 may not go far enough to provide protection against the misuse of hypothetical performance results and, at the same time, may be unduly restrictive on legitimate activities.

The core problem with hypothetical results is that, despite their limited predictive value, some Members induce customers to place undue reliance on hypothetical results. For example, in the past, Members touted dramatic hypothetical returns without revealing that their actual performance results were much worse. The previously submitted amendments to Compliance Rule 2-29 address this specific problem by requiring Members who present hypothetical performance results to also display actual results if any exist.

However, those amendments do not address other ways in which hypothetical results can be misused. For example, prior NFA disciplinary cases illustrate that some Members diminish the effect of poor actual performance results by burying them where customers are less likely to notice or putting them in relatively small print compared to dramatic hypothetical profits which are grossly overemphasized. The same type of difficulties exist with regard to CFTC Regulation 4.41(b)(1)'s disclaimer which is intended to add a balanced view of hypothetical performance results. Specifically, experience has shown that some Members reduce the significance of this disclaimer by utilizing promotional material which either presents hypothetical rates of return in large, bold face print while the disclaimer can be read only with a magnifying glass or places the disclaimer so far from the touted hypothetical profits that customers may never find it.

Due to these remaining problems, the Discussion Group developed a more expansive proposal which imposes further limitations relating to the use of hypothetical performance results in promotional material. This proposal includes additional amendments to Compliance Rule 2-29(c) which adopt an expanded disclaimer and the issuance of an Interpretive Notice Relating to the Use of Promotional Material Containing Hypothetical Performance Results ("Interpretive Notice"). In drafting the expanded disclaimer, the Discussion Group felt that a more thorough discussion of the limitations of hypothetical results and of the dangers of placing reliance upon such results is necessary to adequately protect customers from abuses associated with the use of those results.

In formulating its proposal, the Discussion Group was also aware that the disclaimer, no matter how well worded, will not be effective if Members downplay its significance. Therefore, the Interpretive Notice provides that the disclaimer must be displayed as prominently as the hypothetical results and that it must immediately precede or follow the hypothetical performance results. Furthermore, the Interpretive Notice goes far beyond imposing requirements upon the facial presentation of the disclaimer to require that the promotional material describe all of the material assumptions that were made in preparing the hypothetical performance results. At a minimum, the description of material assumptions must cover points such as initial investment amount, reinvestment or distribution of profits, commission charges, management and incentive fees, and the method used to determine purchase and sale prices for each trade. Finally, the Interpretive Notice provides that any actual results must be presented with at least the same prominence devoted to the hypothetical results. Both the hypothetical and actual performance results must be appropriately identified, separately formatted, discussed in an equally balanced manner and calculated pursuant to the same rate of return method. Under this proposal, no statement can be made which places undue emphasis on the hypothetical performance results by discounting or downplaying the significance of any actual performance results. Admittedly, this proposal places additional restrictions on the use of hypothetical performance results than the recently submitted amendments to Compliance Rule 2-29. However, the Discussion Group felt that this proposal more appropriately addresses the abuses which may arise in connection with the presentation of hypothetical performance results.

In other respects, the Discussion Group also felt that the amendments recently submitted may be unduly restrictive, specifically in its impact on new CPOs and CTAs with less than one year of trading experience. This prohibition could be viewed as raising a potential barrier to entry for new CTAs and CPOs.

In view of the additional protections and restrictions contained in its proposal, the Discussion Group felt that the potential for abuse in the presentation of hypothetical performance results is greatly diminished for both new and experienced Members alike. Admittedly, where the CTA has little or no actual experience, customers would not be afforded the benefit of comparing hypothetical performance results to actual results. However, the expanded disclaimer specifically addresses this point and warns customers that **"Because there are no actual trading results to compare to the hypothetical performance results, customers should be particularly wary of placing undue reliance on these hypothetical performance results."** This language, along with the Interpretive Notice's requirements, should effectively eliminate the ability of Members to induce customers to place undue reliance on hypothetical results.

The proposals of the Discussion Group were approved by the Special Committee and subsequently by NFA's Board of Directors on August 18, 1994. As stated above, NFA hereby substitutes for the text of NFA Compliance Rule 2-29 contained in the March 15, 1994 submission letter the proposed text set forth herein. NFA respectfully requests that the Commission review and approve the proposed amendments to NFA Compliance Rule 2-29 and the proposed adoption of the Interpretive Notice to NFA Compliance Rule 2-29. NFA intends to declare the amendments to Compliance Rule 2-29 and the Interpretive Notice effective upon Commission approval.

Sincerely,

Daniel J. Roth
General Counsel

DJR:ckm(sub\081894.hyp)

cc: Acting Chairman Barbara Pedersen Holum
Commissioner Sheila C. Bair
Commissioner Joseph P. Dial
Commissioner John E. Tull, Jr.
Andrea M. Corcoran, Esq.
Dennis P. Klejna, Esq.
Alan L. Seifert, Esq.
Susan C. Ervin, Esq.
Lawrence B. Patent, Esq.
David Van Wagner, Esq.

NATIONAL FUTURES ASSOCIATION
200 W. MADISON ST • CHICAGO, IL • 60606 • (312) 781-1300

December 28, 1994

Andrea M. Corcoran, Esq.
Director
Division of Trading and Markets
Commodity Futures Trading Commission
2033 K Street, N.W.
Washington, D.C. 20581

Dear Andrea:

This will confirm our conversation of today's date regarding the Interpretive Notice of NFA Compliance Rule 2-13: Break Even Analysis, which is currently pending CFTC approval. As I mentioned, under certain circumstances a Member CPO may have to include an incentive fee calculation in its break even analysis. In some cases, most commonly involving multi-advisor pools, the CTA's incentive fees will be calculated based on its own trading performance and, thus, the pool could incur incentive fees even if its overall performance was negative.

I also stated that it was NFA's intent that with respect to open offerings the break even analysis would have to be updated in subsequent disclosure documents to reflect any material changes in any of the items included in the break even analysis.

NFA staff will recommend that the Board amend the Interpretive Notice to clarify these two points at its next meeting.

If you have any further questions, please do not hesitate to contact me.

Sincerely,

Daniel J. Roth
General Counsel

DJR:ckm(ltr\ac213)

NATIONAL FUTURES ASSOCIATION
200 W. MADISON ST. • CHICAGO, IL • 60606-3447 • (312) 781-1300

March 15, 1995

Ms. Jean A. Webb
Secretariat
Commodity Futures Trading Commission
2033 K Street, N.W.
Washington, D.C. 20581

Re: National Futures Association: Proposed Amendments to Interpretive Notice to NFA Compliance Rule 2-9; Resubmission of Proposed Amendments to NFA Compliance Rule 2-29; Resubmission of Proposed Adoption of Interpretation of NFA Compliance Rule 2-13; Resubmission of Proposed Adoption of NFA Compliance Rule 2-34; and Proposed Adoption of Interpretative Notice to NFA Compliance Rule 2-34

Dear Ms. Webb:

Pursuant to Section 17(j) of the Commodity Exchange Act, as amended ("the Act"), National Futures Association ("NFA") hereby submits to the Commodity Futures Trading Commission ("Commission") proposed amendments to Interpretive Notice to NFA Compliance Rule 2-9 concerning Supervision of Telemarketing Activity; resubmits proposed amendments to NFA Compliance Rule 2-29;[1] resubmits proposed adoption of Interpretation of NFA Compliance Rule 2-13 concerning Break-Even Analysis;[2] resubmits proposed adoption of NFA Compliance Rule 2-34;[3] and submits proposed adoption of Interpretative Notice to NFA Compliance Rule 2-34. NFA hereby substitutes the text of the previously submitted proposals with the revised text set forth herein. The proposals contained herein were approved by NFA's Board of Directors on February 16, 1995. NFA respectfully requests Commission review and approval of them.

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[1] Proposed amendments to NFA Compliance Rule 2-29 were submitted to the Commission for its review and approval by letters dated March 15, 1994 and September 1, 1994.

[2] Proposed adoption of Interpretation of NFA Compliance Rule 2-13 concerning Break-Even Analysis was submitted to the Commission for its review and approval by letter dated March 15, 1994.

[3] Proposed adoption of NFA Compliance Rule 2-34 was submitted to the Commission for its review and approval by letter dated March 15, 1994.

THE PROPOSED AMENDMENTS

A. Proposed Amendments to Interpretive Notice to NFA Compliance Rule 2-9 Concerning Supervision of Telemarketing Activity (additions are underscored and deletions are bracketed):

INTERPRETIVE NOTICE TO COMPLIANCE RULE 2-9: SUPERVISION OF TELEMARKETING ACTIVITY

NFA's Board of Directors has over the years adopted strict and effective rules to prohibit deceptive sales practices, and those rules have been vigorously enforced by NFA's Business Conduct Committees. The Board notes, however, that by their very nature enforcement actions occur after the customer abuse has taken place. The Board recognizes that NFA's goal must be not only to punish such deception of customers through enforcement actions but to prevent it, or minimize its likelihood, through fair and effective regulation.

One NFA rule designed to prevent abusive sales practices is NFA Compliance Rule 2-9. That rule places a continuing responsibility on every Member to supervise diligently its employees and agents in all aspects of their futures activities, including telemarketing. Although NFA has not attempted to prescribe a set of supervisory procedures to be followed by all NFA Members, NFA's Board of Directors believes that Member firms which are identified as having a sales force which has received questionable training in sales practices should be required to adopt specific supervisory procedures designed to prevent sales practice abuse. Rule 2-9 authorizes the Board of Directors to require Members which meet certain criteria established by the Board to adopt specific supervisory procedures designed to prevent abusive sales practices.

The Board believes that in order for the criteria used to identify firms subject to the enhanced supervisory requirements to be useful, those criteria must be specific, objective and readily measurable. The Board also believes that any supervisory requirements imposed on a Member must be designed to quickly identify potential problem areas so that the Member will be able to take corrective action before any customer abuse occurs. The purpose of this Interpretive Notice is to set forth the criteria established by the Board and the enhanced supervisory procedures which are required of firms meeting these criteria.

In developing the criteria, the Board concluded that it would be helpful to review Member firms which had been closed through enforcement actions taken by the CFTC or NFA for deceptive sales practices. The Board's purpose was to identify factors common to these Member firms and probative of their sales practice problems which could be used to identify other Member firms with potential sales practice problems.

One factor identified by the Board as common to these firms and directly related to their sales practice problems is the employment history and training of their sales forces. For many of these Members, a significant portion of their sales force was previously employed and trained by one or more of the other Member firms closed for fraud. The Board believes that the employment history of a Member's sales force is a relevant factor to consider in identifying firms with potential sales practice problems. If a Member firm is closed for fraud related to widespread telemarketing problems, it is reasonable to conclude that the Member's training and supervision of its sales force was wholly inadequate or inappropriate. It is also reasonable to conclude that an AP who received inadequate or inappropriate training and supervision may have learned improper sales tactics which he will carry with him to his next job. Therefore, the Board believes that a Member firm employing such a sales force must have stringent supervision procedures in place in order to ensure that the improper training its APs have previously received does not taint their sales efforts on behalf of the Member.

The Board has determined that a Member will be required to adopt the specific supervisory procedures over its telemarketing activities if:

- for firms with at least 5 but less than 10 APs, [50%] <u>40%</u> or more of its APs have been employed by one or more Member firms which have been disciplined by NFA or the CFTC for sales practice fraud <u>("Disciplined Firms")</u>;
- for firms with at least 10 but less than 20 APs, [5] <u>4</u> or more of its APs have been employed by one or more

NFA

[Member] Disciplined F[f]irms[which have been disciplined by NFA or the CFTC for sales practice fraud];

- for firms with at least 20 or more APs, [25%] 20% or more of its APs have been employed by one or more [Member] Disciplined F[f]irms[which have been disciplined by NFA or the CFTC for sales practice fraud].

For purposes of this requirement, a [d]Disciplined [Member] [f]Firm is defined very narrowly to include only those firms which meet the following three criteria:

1. The firm has been formally charged by either the CFTC or NFA with deceptive telemarketing practices;

2. those charges have been resolved; and

3. the firm has been closed down and permanently barred from the industry as a result of those charges.

Attached is a list of firms currently meeting the definition of a [d]Disciplined [f]Firm. Although this list is current as of the date of this Interpretive Notice, NFA will provide Members with updated lists as necessary.

Those Members meeting the criteria will be required to tape record all [sales solicitations] telephone conversations which occur between their APs and both existing and potential customers[prior to the receipt of a customer's initial deposit and until the first order is received and entered for the customer's account]. The Board believes that tape recording [sales solicitations] these conversations provides these Members with the best opportunity to monitor closely the [sales solicitations] activities of their APs and also provides these Members with complete and immediate feedback on each AP's method of soliciting customers. Members meeting the criteria must tape record [solicitations] all telephone conversations for a period of one year and must retain such tapes for a period of six months.

In addition, those Members meeting the criteria will be required to file all promotional material, as defined in NFA Compliance Rule 2-29(g), with NFA at least ten days prior to its first use.

Any Member required to adopt these enhanced procedures may seek a waiver of the enhanced supervisory requirements. NFA may grant such a waiver upon a satisfactory showing that the Member's current supervisory procedures provide effective supervision over its employees including enabling the Member to identify potential problem areas before customer abuse occurs.

A Member firm that does not comply with this Interpretive Notice will violate NFA Compliance Rule 2-9 and will be subject to disciplinary action.

B. Proposed Amendments to NFA Compliance Rule 2-29 (additions are underscored and deletions are bracketed). The following text replaces the proposed text submitted on March 15, 1994 and September 1, 1994:

COMPLIANCE RULES

* * *

Part 2 -- RULES GOVERNING THE BUSINESS CONDUCT OF MEMBERS REGISTERED WITH THE COMMISSION

* * *

Rule 2-29. COMMUNICATIONS WITH THE PUBLIC AND PROMOTIONAL MATERIAL.

* * *

(b) Content of Promotional Material.

No Member or Associate shall use any promotional material which:

(1) is likely to deceive the public; or

(2) contains any material misstatement of fact or which the Member or Associate knows omits a fact if the omission makes the promotional material misleading; or

(3) mentions the possibility of profit unless accompanied by an equally prominent statement of the risk of loss; or

[(4) includes a measurement or description of or makes any reference to hypothetical results which could have been achieved had a particular trading system been employed in the past unless accompanied by the statement prescribed in CFTC Rule 4.41(b)(1); or]

[(5)] <u>(4)</u> includes any reference to actual past trading profits without mentioning that past results are not necessarily indicative of future results; or

[(6)] <u>(5)</u> includes any specific numerical or statistical information about the past performance of any actual accounts (including rate of return) unless such information is and can be demonstrated to NFA to be representative of the actual performance for the same time period of all reasonably comparable accounts and, in the case of rate of return figures, unless such figures are calculated in a manner consistent with that required under CFTC Rule 4.21(a)(4)(ii)(F).

<u>**(c) Hypothetical Results.**</u>

<u>(1) Any Member or Associate who uses promotional material which includes a measurement or description of or makes any reference to hypothetical performance results which could have been achieved had a particular trading system of the Member or Associate been employed in the past must include in the promotional material the following disclaimer prescribed by NFA's Board of Directors:</u>

> <u>HYPOTHETICAL PERFORMANCE RESULTS HAVE MANY INHERENT LIMITATIONS, SOME OF WHICH ARE DESCRIBED BELOW. NO REPRESENTATION IS BEING MADE THAT ANY ACCOUNT WILL OR IS LIKELY TO ACHIEVE PROFITS OR LOSSES SIMILAR TO THOSE SHOWN. IN FACT, THERE ARE FREQUENTLY SHARP DIFFERENCES BETWEEN HYPOTHETICAL PERFORMANCE RESULTS AND THE ACTUAL RESULTS SUBSEQUENTLY ACHIEVED BY ANY PARTICULAR TRADING PROGRAM.</u>

ONE OF THE LIMITATIONS OF HYPOTHETICAL PERFORMANCE RESULTS IS THAT THEY ARE GENERALLY PREPARED WITH THE BENEFIT OF HINDSIGHT. IN ADDITION, HYPOTHETICAL TRADING DOES NOT INVOLVE FINANCIAL RISK, AND NO HYPOTHETICAL TRADING RECORD CAN COMPLETELY ACCOUNT FOR THE IMPACT OF FINANCIAL RISK IN ACTUAL TRADING. FOR EXAMPLE, THE ABILITY TO WITHSTAND LOSSES OR TO ADHERE TO A PARTICULAR TRADING PROGRAM IN SPITE OF TRADING LOSSES ARE MATERIAL POINTS WHICH CAN ALSO ADVERSELY AFFECT ACTUAL TRADING RESULTS. THERE ARE NUMEROUS OTHER FACTORS RELATED TO THE MARKETS IN GENERAL OR TO THE IMPLEMENTATION OF ANY SPECIFIC TRADING PROGRAM WHICH CANNOT BE FULLY ACCOUNTED FOR IN THE PREPARATION OF HYPOTHETICAL PERFORMANCE RESULTS AND ALL OF WHICH CAN ADVERSELY AFFECT ACTUAL TRADING RESULTS.

If a Member or Associate has either less than one year experience in directing customer accounts or trading proprietary accounts, then the disclaimer must also contain the following statement:

(THE MEMBER) HAS HAD LITTLE OR NO EXPERIENCE IN TRADING ACTUAL ACCOUNTS FOR ITSELF OR FOR CUSTOMERS. BECAUSE THERE ARE NO ACTUAL TRADING RESULTS TO COMPARE TO THE HYPOTHETICAL PERFORMANCE RESULTS, CUSTOMERS SHOULD BE PARTICULARLY WARY OF PLACING UNDUE RELIANCE ON THESE HYPOTHETICAL PERFORMANCE RESULTS.

(2) Any Member or Associate who uses promotional material which includes a measurement or description of or makes any reference to hypothetical performance results which could have been achieved had a particular trading system of the Member or Associate been employed in the past must include in the promotional material comparable information regarding:

(i) past performance results of all customer accounts directed by the Member pursuant to a power of attorney over at least the last five years or over the entire performance history if less than five years; and

(ii) if the Member has less than one year experience in directing customer accounts, past performance results of his proprietary trading over at least the last five years or over the entire performance history if less than five years.

(3) Any Member or Associate utilizing promotional material containing hypothetical performance results must adhere to all the requirements contained in the Board's Interpretive Notice relating to this issue. (See Interpretive Notice at ¶____.)

(4) These restrictions on the use of hypothetical trading results shall not apply to promotional material directed exclusively to persons who meet the standards of a "Qualified Eligible Participant" under CFTC Rule 4.7.

[(c)] (d) **Statements of Opinion.**

* * *

[(d)] (e) **Written Supervisory Procedures.**

* * *

[(e)] (f) **Recordkeeping.**

* * *

[(f)] (g) **Filing with NFA.**

* * *

[(g)] (h) **Definition.**

* * *

C. **Proposed Adoption of Interpretation of NFA Compliance Rule 2-13 Concerning Break-Even Analysis. The following text replaces the proposed text submitted on March 15, 1994:**

INTERPRETATION OF NFA COMPLIANCE RULE 2-13
BREAK-EVEN ANALYSIS

NFA Compliance Rule 2-13 requires, in pertinent part, that each Member CPO which delivers a disclosure document under the CFTC Regulation 4.21 must include in the disclosure document a break-even analysis which includes a tabular presentation of fees and expenses. The break-even analysis must be presented in the manner prescribed by NFA's Board of Directors. The purpose of this requirement is to ensure not only that customers will be clearly informed as to the nature and amount of fees and expenses that will be incurred, but that customers will also be made aware of the impact of those fees and expenses on the potential profitability of their investments. NFA's Board of Directors has adopted the following guidelines which must be adhered to by NFA Member CPOs when preparing the break-even analysis required by Compliance Rule 2-13:

- If fees are likely to be affected by the size of the offering, then an assumed amount of total funds raised should be stated. The document should also state what the break-even point would be if the minimum or maximum proceeds were raised.

- If there are redemption fees, they must be clearly shown and considered part of the total cost and reflected in the break-even analysis.

- Incentive fees should be stated as a percentage of profits, and the method by which profits are calculated should be described.

- All management, brokerage and other fees should reflect actual experience or contractual charges, if known. If not known, they should be based on good faith estimates. If, for example, CTAs publish their estimated number of round turns/ $1,000,000 then those published estimates should be used for estimating brokerage costs. If this is an on-going fund or if there is evidence supporting other numbers, then the other numbers should be used and explained.

To calculate the break-even point a CPO must first determine the amounts of all fees and expenses, exclusive of incentive fees, that are anticipated to be incurred by the pool during the first year of the investment. The total of these fees and expenses less the amount of interest income expected to be earned by the pool represents the gross trading profits before incentive fees (preliminary gross trading profits) that would be necessary for the pool to retain its initial Net Asset Value per unit at the end of the first year. In some situations the CPO must then calculate the additional trading profit that would be necessary to overcome the incentive fees that would be incurred. This situation will arise whenever the pool expects to incur expenses which would not be deducted from the CTA's net performance in calculating the CTA's incentive fee. That amount can be computed by first determining the incentive fees that would be incurred if the preliminary gross trading profits described above were achieved and then dividing that amount by (1- incentive fee rate); e.g., if the incentive fee is 25%, the denominator would be 1- .25, or .75. A sample break-even presentation is shown below:

Selling Price per Unit (1)	$ 1,000.00
Syndication and Selling Expense (1)	$ 50.00
General Partner's Management Fee (2)	9.50
Fund Operating Expenses (3)	20.50
Trading Advisor's and Trading Manager's Management Fees (4)	28.50
Trading Advisor's and Trading Manager's Incentive Fees on Trading Profits (5)	17.17
Brokerage Commissions and Trading Fees (6)	38.00
Less Interest Income (7)	(28.50)
Amount of Trading Income Required for the Fund's Net Asset Value per Unit (Redemption Value) at the End of One Year to Equal the Selling Price per Unit	$ 135.17
Percentage of Initial Selling Price per Unit	13.52%

Explanatory Notes:

(1) Investors will initially purchase units at $1,000. After the commencement of trading, units will be purchased at the Fund's month-end Net Asset Value per unit. A 5% syndication and selling charge will be deducted from each subscription to reimburse the Fund, the General Partner and/or the Clearing Broker for the syndication and selling expenses incurred on behalf of the Fund.

(2) Except as set forth in these explanatory notes, the illustration is predicated on the specific rates or fees contracted by the Fund with the General Partner, the Trading Manager, the Trading Advisor, and the Clearing Broker, as described in "Fees, Compensation and Expenses."

(3) The Fund's actual accounting, auditing, legal and other operating expenses will be borne by the Fund. These expenses are expected to amount to approximately 2.05% of the Fund's Net Asset Value.

(4) The Fund's Trading Advisor will be paid a monthly management fee of 1/2 of 2% of Allocated Net Assets. The fund's Trading Manager will be paid a monthly management fee of 1/12 of 1% of allocated Net Assets.

(5) The Trading Advisor and Trading Manager will receive incentive fees of 20% and 5%, respectively, of Trading Profits exclusive of interest income. The $17.17 of incentive fees shown above is equal to 25% of the net of total trading income of $135.17, minus $38.00 of brokerage commissions and trading fees and $28.50 of management fees.

(6) Brokerage commissions and trading fees are estimated at 4% of Net Asset Value.

(7) The Fund will earn interest on margin deposits with its Clearing Broker. Based on current interest rates, interest income is estimated at 3% of Net Asset Value.

D. **Proposed Adoption of NFA Compliance Rule 2-34 and Interpretive Notice to NFA Compliance Rule 2-34. The following text of Compliance Rule 2-34 replaces the proposed text submitted on March 15, 1994:**

COMPLIANCE RULES

* * *

Part 2 -- RULES GOVERNING THE BUSINESS CONDUCT OF MEMBERS REGISTERED WITH THE COMMISSION

* * *

Rule 2-34. DIRECTED ACCOUNTS AND COMMODITY POOLS

(a) At the time a Member CTA enters into an agreement to direct a client's account, the Member CTA must obtain a written agreement signed by the client (or someone legally authorized to act on the client's behalf) which states:

(1) the account size which the CTA will use as the basis for its trading decisions, i.e., "the nominal account size";

(2) the name or description of the trading program in which the client is participating;

(3) whether the client will deposit, maintain or make accessible to the FCM an amount equal to or less than the nominal account size, i.e., to fully or partially fund the account; and

(4) how additions, withdrawals, profits and losses will affect the nominal account size and the computation of fees.

The Member CTA must provide a copy of the agreement to the FCM carrying the account. The Member CTA must also disclose in writing the factors considered by the CTA in determining any minimum account size of the trading program in which the client is participating.

(b) Unless the client is a qualified eligible client under CFTC Regulation 4.7, any Member CTA which directs a partially funded account must provide the following information in writing to the client:

(1) an estimated range of the amount of customer equity generally devoted to margin requirements or options premiums expressed as a percentage of the nominal account size and an explanation of the effect of partially funding an account on that percentage;

(2) a description of how the management fees will be computed, expressed as a percentage of the nominal account size and an explanation of the effect of partially funding an account on that percentage;

(3) 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 that percentage;

(4) a statement 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 possible size of, margin calls.

(c) Unless the pool participants are qualified eligible participants under CFTC Regulation 4.7, any Member CPO which allocates assets among the pool's CTAs in such a way that the total allocations to its CTAs is greater than the total assets of the pool must provide the following information in writing to the pool participants:

(1) a statement of the total amount allocated to CTAs as a percentage of the pool's net assets;

(2) a description of how management fees charged by the CPO and the CTAs will be computed, including a statement of the total amount of management fees charged to the pool as a percentage of the pool's net assets;

(3) an estimated range of the amount of commissions and transaction fees which will be charged to the pool in the next twelve months and an estimate of

such fees as a percentage of the pool's net assets; and

(4) a statement that allocating in excess of the pool's net assets among CTAs has the effect of proportionately magnifying the profits and losses which may be incurred by the pool.

(d) Each CTA Member which directs accounts and each CPO Member which allocates assets among CTAs in such a way that the total committed is greater than the total assets of the pool shall maintain the records required by this Rule in the form and for the period of time required by CFTC Regulation 1.31.

(e) Each CTA Member which directs accounts and each CPO Member to which this rule applies allocates assets among CTAs in such a way that the total allocated is greater than the total assets of the pool shall establish and enforce adequate procedures to review all records made pursuant to this Rule and to supervise the activities of its Associates in complying with this Rule.

# # # #

INTERPRETIVE NOTICE
NFA COMPLIANCE RULE 2-34

The Board of Directors recently passed NFA Compliance Rule 2-34, Documentation and Disclosure for Partially Funded Accounts. The Board recognized that certain customers may, for their own legitimate business purposes, deposit with the FCMs carrying their accounts less than the amount which they have directed the CTA trading their account to use as the basis for trading decisions. The Board sought to ensure that in such situations performance records accurately reflect trading results, that there is an adequate audit trail to verify past performance records and that customers receive adequate disclosures on the implications of partially funded accounts.

In the Board's view, the solicitation of partially funded accounts, particularly with less sophisticated customers, raises a number of compliance issues. Therefore, the Board wishes to make clear that NFA Compliance Rule 2-34 does not in any way diminish a Member's responsibilities under other NFA rules, most notably NFA's sales practice rules, when dealing with a customer who is considering a partially funded account.

Specifically, the Member must ensure that any solicitation present a balanced view of the risks and benefits of such an arrangement and disclose all material information. Furthermore, under NFA Compliance Rule 2-30, the Member must obtain the specified information regarding its customer's experience and financial condition and, in light of that information, must provide the customer with an adequate description of the risks of his investment. As the Board stated in its Interpretive Notice of that rule, for some customers the only adequate disclosure is that futures trading is simply too risky for that customer. That is particularly true when retail customers are induced to increase their leverage further by partially funding a trading account.

Any Member soliciting unsophisticated customers to trade with a partially funded account will bear the burden of demonstrating that its solicitation was in compliance with all NFA requirements.

EXPLANATIONS OF PROPOSALS

A. Explanation of Proposed Amendments to Interpretive Notice to NFA Compliance Rule 2-9 Concerning Supervision of Telemarketing Activity

As approximately two years have passed since the Commission approved the amendment to NFA Compliance Rule 2-9 and the Interpretive Statement concerning Supervision of Telemarketing Activity, NFA determined to review the effectiveness of the Telemarketing Requirements. Overall, NFA found that the Telemarketing Requirements have been very useful to gather evidence in enforcement actions relating to deceptive telemarketing sales activities. NFA believes that the general decline in customer complaints and arbitration demands received by NFA during the last two years provides evidence that the Telemarketing Requirements have reduced the occurrence of widespread telemarketing fraud. While NFA's review illustrated the overall effectiveness of the Telemarketing Requirements, the review also indicated that certain minor amendments to the Interpretive Notice may offer increased protection against fraudulent sales practices.

As the Commission is aware, the current Interpretive Notice to NFA Compliance Rule 2-9 concerning Supervision of Telemarketing Activity requires an NFA Member firm which meets specific criteria relating to the employment history of its APs to adopt supervisory procedures for the supervision of telemarketing. The amended Interpretive Notice makes this criteria more stringent by establishing a lower "trigger" for Member firms to adopt the Telemarketing Requirements.

The current Interpretive Notice to NFA Compliance Rule 2-9 requires Members meeting the Telemarketing Requirements' criteria to tape record all sales solicitations which occur prior to the receipt of a customer's initial deposit and until the first order is received and entered for a customer's account. While this taping requirement substantially deters APs from making misleading statements during initial sales solicitations, recent NFA disciplinary cases indicate that in some instances the most egregious sales practice violations occur after the customer has already begun trading. To address this problem, the amended Interpretive Notice requires Members meeting the Telemarketing Requirements' criteria to tape record <u>all</u> telephone conversations which occur between their APs and both existing and potential customers.

While the current Interpretive Notice does not address the use of promotional material by Members meeting the Telemarketing Requirements' criteria, prior NFA disciplinary cases indicate that Member firms which had lax supervisory requirements relating to telemarketing had similar lax requirements relating to the review and use of promotional material. The amended Interpretive Notice requires Members meeting the Telemarketing Requirements' criteria to file all promotional material, as defined in NFA Compliance Rule 2-29(g), with NFA at least ten days prior to its first use.

B. Explanation of Proposed Amendments to NFA Compliance Rule 2-29

By letters dated March 15, 1994 and September 1, 1994, NFA submitted for the Commission's review and approval proposed amendments to NFA Compliance Rule 2-29 concerning hypothetical trading results in promotional material. Since that time, Commission staff has requested NFA staff to delete a sentence in the first paragraph of the disclaimer in Compliance Rule 2-29(c) that read, "AS A RESULT OF THESE LIMITATIONS, HYPOTHETICAL PERFORMANCE RESULTS HAVE LIMITED PREDICTIVE VALUE." The Commission requested that it be replaced with the last sentence of the Commission's current disclaimer which reads, "NO REPRESENTATION IS BEING MADE THAT ANY ACCOUNT WILL OR IS LIKELY TO ACHIEVE PROFITS OR LOSSES SIMILAR TO THOSE SHOWN." The proposed text of NFA Compliance Rule 2-29 contained herein reflects those requested changes.

C. Explanation of Proposed Adoption of Interpretation of NFA Compliance Rule 2-13 Concerning Break-Even Analysis

By letter dated March 15, 1994, NFA submitted for the Commission's review and approval a proposed Interpretation of NFA Compliance Rule 2-13 concerning Break-Even Analysis. The interpretation includes a calculation of the additional trading profit which would be necessary to overcome incentive fees that would be incurred by the pool. Commission staff has requested NFA staff to add a sentence to the interpretation to clarify that this calculation would be necessary whenever the pool expects to incur expenses which would not be deducted from the CTA's net performance in calculating the CTA's incentive fee. The proposed text of the Interpretation to NFA Compliance Rule 2-13 contained herein makes that clarification in the sixth paragraph.

D. Explanation of Proposed Adoption of NFA Compliance Rule 2-34 and the Adoption of its Interpretive Notice

One of the most important proposals developed by the Special Committee for the Review of CPO/CTA Disclosure Issues involved the issue of notional funding. NFA's proposal was premised on the belief that the disclosure and sales practice issues associated with notional funding of accounts are best addressed through NFA Compliance Rules tailored to deal with those specific issues, rather than through a tortuous interpretation of rules related to the presentation of past performance information.

By letter dated March 15, 1994, NFA submitted for the Commission's review and approval proposed adoption of NFA Compliance Rule 2-34 which deals with those issues, in part, by requiring each CTA to have a signed agreement for each of its accounts which would state:

- the name of the trading program the client is participating in;
- the nominal account size which the CTA will use as the basis for its trading decisions;
- whether the customer intends to fully fund the nominal account size; and
- how profits and losses will affect the nominal account size.

The proposed rule also provides that a copy of the signed agreement would have to be provided to the FCM carrying the account. In addition, if the customer is not fully funding his account, the CTA would be required to provide the customer with written information regarding the effect of partially funding his account on management fees, commissions and the frequency of margin calls. Analogous disclosures would have to be made by CPOs who allocate pool assets among CTAs in such a way that the total amount allocated exceeds the total assets of the pool.

Commission staff has had ongoing discussions with NFA staff regarding this proposal. The Commission staff has stated that their concerns with NFA's proposal center on three points:

(1) by allowing the notional funding level to be used in the calculation of past performance data, we may encourage the use of notional funding by CTAs for "retail" accounts, thus creating sales practice problems in the solicitation of unsophisticated customers;

(2) the proposed rule needs more specific disclosure requirements regarding the effect of partial funding on management fees and commissions; and

(3) there is a general concern that the notional funding level is determined by the CTA rather than the customer and represents an arbitrary

figure which is not linked in any real sense to the actual trading in the account.

The proposed text of NFA Compliance Rule 2-34 contained herein addresses the points raised by the Commission staff. With respect to the sales practice concerns, NFA has always maintained that nothing in the proposed rule in any way diminishes the obligations of NFA Members under our existing sales practice rules. For example, NFA's Know Your Customer Rule requires that Members obtain information on each customer's financial condition and provide the customer with risk disclosures which are adequate in light of the customer's situation. The Interpretive Notice for that rule makes clear that for some customers the only adequate disclosure of risk is that futures trading is too risky for that customer.

The same rule would apply with equal vigor to situations in which customers of limited means or trading experience were solicited to open a partially funded managed account. The Member would still be required to provide the customers with adequate disclosures, which in some cases would require disclosure that the customer ought not be trading on a partially funded basis. The proposed Interpretive Notice makes this point clear.

NFA believes that the proposed text of NFA Compliance Rule 2-34 contained herein is responsive to the Commission while remaining faithful to the basic concept of the proposed rule. Aside from minor wording or organizational changes, there are three basic differences between the originally submitted text of the rule and the text contained herein. First, the version herein clarifies the requirement that CTAs explain how management fees would be calculated for partially funded accounts by specifying that management fees must be stated as a percentage of the nominal account size and of the funds actually deposited with the FCM.

Two other changes are intended to address the concern that the nominal account size figure is purely arbitrary and bears no relation to how the account is traded. The CTA would be required to provide each client with a written explanation of the factors considered by the CTA in determining the minimum account size for that particular trading program. This explanation could be included in the disclosure document, perhaps in conjunction with a description of the trading program. The CTA would also be required to provide the customer with an estimated range of the amount of customer equity which would generally be devoted to margin requirements or option premiums. This estimated range would be expressed as a percentage of both the nominal account size and the funds actually deposited.

NFA respectfully requests that the Commission review and approve the proposals contained in this submission and requests that they be declared effective upon Commission approval.

Respectfully submitted,

Daniel J. Roth
General Counsel

cc: Chairman Mary L. Schapiro
Commissioner Barbara Pedersen Holum
Commissioner Sheila C. Bair
Commissioner Joseph P. Dial
Commissioner John E. Tull, Jr.
Andrea M. Corcoran, Esq.
Dennis P. Klejna, Esq.
Alan L. Seifert, Esq.
Susan C. Ervin, Esq.
Lawrence B. Patent, Esq.
David Van Wagner, Esq.

DJR:ckm(sub\021695)

UNITED STATES OF AMERICA
COMMODITY FUTURES TRADING COMMISSION
2033 K Street, N.W.
Washington, D.C. 20581

April 26, 1995

Mr. Daniel J. Roth
General Counsel
National Futures Association
200 West Madison Street
Chicago, Illinois 60606

Re: The National Futures Association's Proposed Amendment to Compliance Rule 2-13(b) and Proposed Interpretive Notice to Compliance Rule 2-13(b)

Dear Mr. Roth:

By letters dated March 15, 1994 through March 15, 1995, the National Futures Association ("NFA") submitted to the Commission the above-referenced proposed amendment and interpretive notice to Compliance Rule 2-13(b) pursuant to Section 17(j) of the Commodity Exchange Act.

Please be advised that on this date the Commission has determined to approve the NFA's proposed amendment and interpretive notice to Compliance Rule 2-13(b) pursuant to Section 17(j) of the Commodity Exchange Act.

The Commission has based its approval of NFA's proposal upon, amongst other things, the understanding that NFA will be amending the interpretive notice in the near future to clarify that commodity pool operators with continuously-offered pools must include updated break-even analyses in their disclosure documents throughout their existence such that each new participant would be informed of a break-even point which was accurate as of the date of the disclosure document.

The Commission understands that NFA's proposal is intended to ensure that potential investors are provided with a fair representation of the costs of investing in a pool. Accordingly, the Commission reminds the NFA that in explaining and enforcing member compliance with its break-even analysis requirements, it should not consider the categories of fees and expenses in the proposed interpretive notice to Compliance Rule 2-13(b) to be an exhaustive listing of a pool's possible types of fees and expenses, and NFA should ensure that commodity pool operators do not rely on the interpretive notice's categorical listing to avoid including some cost in a pool's break-even analysis. In this connection, the Commission understands that NFA would require that a projection of expected interest income in a pool's break-even analysis include the assumed interest rate and that such rate reflect current cash market information. In addition, to the extent that the commodity pool operator or any party other than a participant in a pool receives some portion of the pool's interest income, it should be disclosed as a fee or expense in the pool's break-even analysis.

The Commission further reminds the NFA that if the amendment and interpretive notice to Compliance Rule 2-13(b) are inconsistent with the Commission's final rulemaking on break-even analyses, NFA would have to amend its requirements appropriately.

Sincerely,

Jean A Webb

Jean A. Webb
Secretary of the Commission

NATIONAL FUTURES ASSOCIATION
200 W. MADISON ST. • CHICAGO, IL • 60606-3447 • (312) 781-1300

September 21, 1995

Ms. Jean A. Webb
Secretariat
Commodity Futures Trading Commission
Three Lafayette Centre
1155 21st Street, N.W.
Washington, D.C. 20581

Re: National Futures Association: Resubmission of Proposed Amendments to NFA Compliance Rule 2-29 and the Proposed Adoption of Its Interpretive Notice Concerning Hypothetical Trading Results; and Withdrawal of Submission of Proposed Interpretive Notice to Rule 2-13 Concerning Presentation of Past Performance Information

Dear Ms. Webb:

By letters dated March 15, 1994, September 1, 1994 and March 15, 1995, National Futures Association ("NFA") submitted to the Commodity Futures Trading Commission ("Commission" or "CFTC") for its review and approval proposed amendments to NFA Compliance Rule 2-29. NFA hereby substitutes the text of the previously submitted proposals with the text set forth herein.

In addition, by letter dated September 1, 1994, NFA submitted to the Commission for its review and approval the proposed adoption of an Interpretive Notice to NFA Compliance Rule 2-29 relating to the use of promotional material containing hypothetical performance results. NFA hereby substitutes the text of the previously submitted proposal with the revised text set forth herein. The proposal contained herein was approved by NFA's Board of Directors ("Board") on August 17, 1995.

Furthermore, by letter dated March 15, 1994, NFA submitted to the Commission for its review and approval, among other things, the proposed adoption of an Interpretive Notice to NFA Compliance Rule 2-13 Concerning the Presentation of Past Performance Information. As most of the recommendations set forth in that Interpretive Notice have been incorporated in the Commission's recent amendments to its Part 4 disclosure rules, NFA hereby withdraws its submission of the proposed Interpretive Notice to Rule 2-13. However, sections of that Interpretive Notice dealing with <u>pro forma</u> and extracted results have been incorporated into the proposed Interpretive Notice concerning hypothetical results contained herein.

NFA respectfully requests Commission review and approval of the following proposed amendments to NFA Compliance Rule 2-29 and its proposed Interpretive Notice.

THE PROPOSED AMENDMENTS

A. Proposed Amendments to NFA Compliance Rule 2-29 (additions are underscored and deletions are bracketed). The following text replaces the proposed text submitted on March 15, 1994, September 1, 1994 and March 15, 1995.

COMPLIANCE RULES

* * *

Part 2 -- RULES GOVERNING THE BUSINESS CONDUCT OF MEMBERS REGISTERED WITH THE COMMISSION

* * *

Rule 2-29. COMMUNICATIONS WITH THE PUBLIC AND PROMOTIONAL MATERIAL.

* * *

(b) Content of Promotional Material.

No Member or Associate shall use any promotional material which:

(1) is likely to deceive the public; or

(2) contains any material misstatement of fact or which the Member or Associate knows omits a fact if the omission makes the promotional material misleading; or

(3) mentions the possibility of profit unless accompanied by an equally prominent statement of the risk of loss; or

[(4) includes a measurement or description of or makes any reference to hypothetical results which could have been achieved had a particular trading system been employed in the past unless accompanied by the statement prescribed in CFTC Rule 4.41(b)(1); or]

[(5)] (4) includes any reference to actual past trading profits without mentioning that past results are not necessarily indicative of future results; or

[(6)] (5) includes any specific numerical or statistical information about the past performance of any actual accounts (including rate of return) unless such information is and can be demonstrated to NFA to be representative of the actual performance for the same time period of all reasonably comparable accounts and, in the case of rate of return figures, unless such figures are calculated in a manner consistent with that required under CFTC Rule 4.21(a)(4)(ii)(F).

(c) Hypothetical Results.

(1) Any Member or Associate who uses promotional material which includes a measurement or description of or makes any reference to hypothetical performance results which could have been achieved had a particular trading system of the Member or Associate been employed in the past must include in the promotional material the following disclaimer prescribed by NFA's Board of Directors:

HYPOTHETICAL PERFORMANCE RESULTS HAVE MANY INHERENT LIMITATIONS, SOME OF WHICH ARE DESCRIBED BELOW. NO REPRESENTATION IS BEING MADE THAT ANY ACCOUNT WILL OR IS LIKELY TO ACHIEVE PROFITS OR LOSSES SIMILAR TO THOSE SHOWN. IN FACT, THERE ARE FREQUENTLY SHARP DIFFERENCES BETWEEN HYPOTHETICAL PERFORMANCE RESULTS AND THE ACTUAL RESULTS SUBSEQUENTLY ACHIEVED BY ANY PARTICULAR TRADING PROGRAM.

ONE OF THE LIMITATIONS OF HYPOTHETICAL PERFORMANCE RESULTS IS THAT THEY ARE GENERALLY PREPARED WITH THE BENEFIT OF HINDSIGHT. IN ADDITION, HYPOTHETICAL TRADING DOES NOT INVOLVE FINANCIAL RISK, AND NO HYPOTHETICAL TRADING RECORD CAN COMPLETELY ACCOUNT FOR THE IMPACT OF FINANCIAL RISK IN ACTUAL TRADING.

FOR EXAMPLE, THE ABILITY TO WITHSTAND LOSSES OR TO ADHERE TO A PARTICULAR TRADING PROGRAM IN SPITE OF TRADING LOSSES ARE MATERIAL POINTS WHICH CAN ALSO ADVERSELY AFFECT ACTUAL TRADING RESULTS. THERE ARE NUMEROUS OTHER FACTORS RELATED TO THE MARKETS IN GENERAL OR TO THE IMPLEMENTATION OF ANY SPECIFIC TRADING PROGRAM WHICH CANNOT BE FULLY ACCOUNTED FOR IN THE PREPARATION OF HYPOTHETICAL PERFORMANCE RESULTS AND ALL OF WHICH CAN ADVERSELY AFFECT ACTUAL TRADING RESULTS.

If a Member or Associate has either less than one year experience in directing customer accounts or trading proprietary accounts, then the disclaimer must also contain the following statement:

(THE MEMBER) HAS HAD LITTLE OR NO EXPERIENCE IN TRADING ACTUAL ACCOUNTS FOR ITSELF OR FOR CUSTOMERS. BECAUSE THERE ARE NO ACTUAL TRADING RESULTS TO COMPARE TO THE HYPOTHETICAL PERFORMANCE RESULTS, CUSTOMERS SHOULD BE PARTICULARLY WARY OF PLACING UNDUE RELIANCE ON THESE HYPOTHETICAL PERFORMANCE RESULTS.

(2) Any Member or Associate who uses promotional material which includes a measurement or description of or makes any reference to hypothetical performance results which could have been achieved had a particular trading system of the Member or Associate been employed in the past must include in the promotional material comparable information regarding:

(i) past performance results of all customer accounts directed by the Member pursuant to a power of attorney over at least the last five years or over the entire performance history if less than five years; and

(ii) if the Member has less than one year experience in directing customer accounts, past performance results of his proprietary trading over at least the last five years or over the entire performance history if less than five years.

(3) Any Member or Associate utilizing promotional material containing hypothetical performance results must adhere to all the requirements contained in the Board's Interpretive Notice relating to this issue. (See Interpretive Notice at ¶ .)

(4) These restrictions on the use of hypothetical trading results shall not apply to promotional material directed exclusively to persons who meet the standards of a "Qualified Eligible Participant" under CFTC Rule 4.7.

[(c)] (d) **Statements of Opinion.**

* * *

[(d)] (e) **Written Supervisory Procedures.**

* * *

[(e)] (f) **Recordkeeping.**

* * *

[(f)] (g) **Filing with NFA.**

* * *

[(g)] (h) **Definition.**

* * *

B. **Proposed Adoption of an Interpretive Notice to NFA Compliance Rule 2-29 Relating to the Use of Promotional Material Containing Hypothetical Performance Results. The following text replaces the proposed text submitted on September 1, 1994.**

NFA COMPLIANCE RULE 2-29

INTERPRETIVE NOTICE RELATING TO THE USE OF PROMOTIONAL MATERIAL CONTAINING HYPOTHETICAL PERFORMANCE RESULTS

Over the years the use of hypothetical performance results has repeatedly produced highly misleading promotional material. By their very nature, such performance results have certain limitations. For example, hypothetical performance results do not represent actual trading and are generally designed with the benefit of hindsight which may under- or over-compensate for the impact of certain market factors, including lack of liquidity and price slippage. Furthermore, since hypothetical trading does not involve financial risk, no hypothetical performance results can completely account for the impact of certain factors associated with risk, including the ability of the customer or the advisor to withstand losses or to adhere to a particular trading program in the face of trading losses. Despite these limitations, there have been numerous instances in which Members in one form or another have attempted to induce customers to place undue reliance on hypothetical results. NFA's Business Conduct Committee has not hesitated to issue charges against Members engaging in such practices and will continue to pay close attention to advertising materials which display hypothetical results.

The use of hypothetical results has been the subject of regulatory scrutiny before. In 1981, the Commodity Futures Trading Commission ("CFTC" or "Commission") considered a total ban on the use of such results. Ultimately, the Commission determined to require CPOs and CTAs displaying hypothetical results to display the disclaimer set forth in CFTC Regulation 4.41. The Commission noted at the time that it might well impose sterner measures if the disclaimer proved ineffective at preventing abuses. NFA subsequently required all NFA Members and Associates to display Regulation 4.41's disclaimer in any promotional material which contains such results.

In NFA's experience, however, the use of the mandated disclaimer has not prevented recurring abuses in the presentation of hypothetical results. In some instances Members have touted dramatic hypothetical profits without revealing that their actual performance is much worse. This situation has been addressed by an amendment to NFA Compliance Rule 2-29(c)(2) which requires Members advertising hypothetical results to disclose their actual results as well. In other cases Members have effectively diminished the impact of the disclaimer by grossly over-emphasizing the significance of very dramatic hypothetical profits. For example, some Members have utilized promotional material which present hypothetical rates of return in large, bold face print while the disclaimer can be read only with a magnifying glass. In other advertising pieces the disclaimer is so far removed from the touted hypothetical profits that customers may never find it. There have also been instances in which Members or Associates have attempted to disguise hypothetical performance results as actual performance results.

Due to these problems, NFA's Board of Directors recently reviewed whether NFA Members and Associates should be permitted to utilize hypothetical performance results in promotional material. During this review, the Board considered a complete ban on the presentation of these results in promotional material due to its potentially abusive and misleading nature. However, in considering such a ban, the Board also recognized that the presentation of hypothetical performance results in promotional material may have some limited utility in certain circumstances, for example, where a CTA has developed a new trading program for which there are no actual trading results. As a result, the Board decided to continue to allow Members and Associates to utilize promotional material containing hypothetical performance results under very stringent restrictions. Hypothetical results will not be allowed, however, for any trading program for which the Member has three months of actual trading results. Any Member or Associate utilizing promotional material which includes hypothetical results shall, at a minimum, adhere to the following requirements.

First, any Member or Associate utilizing promotional material which presents hypothetical performance results must provide to customers the disclaimer contained in NFA Compliance Rule 2-29(c)(1). The Board has expanded the required disclaimer to provide a more thorough discussion of the limitations of hypothetical results and of the dangers in placing reliance upon them. To prevent the over-emphasis of hypothetical performance results, the disclaimer must be displayed as prominently as the hypothetical results themselves. Generally, this would require that the disclaimer be printed in a type size at least as large as that used for the hypothetical results. Similarly, to avoid circumstances where hypothetical performance results are presented in one section of the promotional material with the disclaimer buried in another, the disclaimer must now immediately precede or follow the performance results. Whenever the Member or Associate has less than twelve months of actual results, the disclaimer must immediately precede the hypothetical performance results. Furthermore, if the promotional material contains several pages of hypothetical performance results, then the Member or Associate may need to include this disclaimer more than once in the material.

Second, any Member or Associate utilizing promotional material which presents hypothetical performance results must also describe in the promotional material all of the material assumptions that were made in preparing the hypothetical results. At a minimum, the description of material assumptions must cover points such as initial investment amount, reinvestment or distribution of profits, commission charges, management and incentive fees, and the method used to determine purchase or sale prices for each trade. Members must also make all material disclosures necessary to place the hypothetical results in their proper context, which in some instances may go well beyond the prescribed disclaimer. Furthermore, Members and Associates must calculate hypothetical performance results in a manner consistent with that required under the CFTC's Part 4 Regulations.

Third, when any Member or Associate utilizes promotional material which contains both hypothetical and actual performance results, then the actual results must be presented with at least the same prominence devoted to the hypothetical results. Both the hypothetical and actual performance results must be appropriately identified, separately formatted, discussed in an equally balanced manner and calculated pursuant to the same rate of return method. Furthermore, the promotional material must not contain any statement which places undue emphasis on the hypothetical performance results, for example, by discounting or downplaying the significance of any actual performance results.

The presentation of hypothetical performance results in promotional material is, of course, subject to all other NFA Requirements. Pursuant to NFA Compliance Rule 2-29(b)(1) and (2), the ultimate test of any promotional material is whether the overall impact of the material is misleading or likely to deceive the public. Although NFA has issued this Interpretive Notice, the Board recognizes that it cannot describe every manner in which promotional material containing hypothetical performance results may be misleading. The fact that an NFA Member or Associate has printed the disclaimer required pursuant to NFA Compliance Rule 2-29 and that the promotional material is in facial compliance with this Interpretive Notice does not ensure that material is not misleading.

Promotional material which contains hypothetical performance results will continue to be carefully scrutinized by NFA staff. Pursuant to NFA Compliance Rule 2-29(e), Members and Associates presenting hypothetical results in their promotional material must be able to demonstrate to NFA's satisfaction the validity of the presentation of the results. The greater the emphasis on dramatic hypothetical profits, the greater the Member's burden in demonstrating the validity of the presentation.

The use of _pro forma_ and extracted results are two other areas in which a hindsight analysis can lead to misleading promotional material. The Board of Directors believes that the use of _pro forma_ performance histories can present useful information to customers, particularly when used to show how the past performance of a given Member or Associate would have been affected by the commission or fee structure which applies to the futures or options contracts, commodity pool, or trading program the Member or Associate is offering, recommending, or providing information on. Therefore, a Member or Associate may use _pro forma_ results to adjust for differences in commissions and fees as long as the _pro forma_ results are not calculated in a misleading manner. Members and Associates may not, however, use _pro forma_ results which reflect a hindsight analysis. For example, CPOs may not use _pro forma_ results to show what results a multi-advisor pool could have achieved in the past if the pool's assets had been allocated among particular CTAs in a certain proportion.

Hindsight analysis may also play a part in the presentation of "extracted performance" in which a Member or Associate selects one component of its overall past trading results to highlight to customers. In order to prevent the misleading use of such results, the use of extracted performance is permitted only when a CPO's or CTA's previous disclosure documents designated the percentage of assets which would be committed toward that particular component of the overall trading program. For example, if the previous disclosure document stated that 25% of a fund's assets would be dedicated to trading financial futures contracts, and if 25% of the fund's assets were in fact dedicated to trading financial futures contracts, the CPO would be allowed to present the extracted performance of its financial futures trading based on net asset values equal to 25% of the fund's total net asset value. Performance may also be extracted from a managed account program run by an FCM or IB if these same requirements are met. In other words, the FCM or IB must have previously prepared and distributed to all customers participating in the trading program a written report or similar document which designated the percentage of assets which would be committed toward that particular component of the overall trading program. Oral representations, or written documents which were not distributed to the customers, are not sufficient. Furthermore, any promotional material referring to extracted results must clearly label those results as such and must disclose in an equally prominent fashion the overall actual trading results from which the extracted results were drawn.

EXPLANATION OF AMENDMENTS

A. Explanation of Proposed Amendments to NFA Compliance Rule 2-29

By letters dated March 15, 1994, September 1, 1994 and March 15, 1995, NFA submitted for the Commission's review and approval proposed amendments to NFA Compliance Rule 2-29 concerning hypothetical trading results in promotional material. The proposed amendments to Compliance Rule 2-29 have not changed since March 15, 1995, and they are included here solely for ease of reference in the Commission's review of the proposed interpretive notice to that rule. An explanation of the proposed amendments to Compliance Rule 2-29 can be found in the March 15, 1994, September 1, 1994 and March 15, 1995 submissions.

B. Explanation of Proposed Interpretive Notice to NFA Compliance Rule 2-29 Relating to the Use of Promotional Material Containing Hypothetical Performance Results

By letter dated September 1, 1994, NFA submitted for the Commission's review and approval the proposed adoption of an Interpretive Notice to NFA Rule 2-29. Since that time, Commission staff had asked NFA to consider amending the proposed Interpretive Notice to provide that Members could not present hypothetical trading results for any program for which they have actual results. The Interpretive Notice as proposed herein provides for this.

Furthermore, in its March 15, 1994 letter to the Commission NFA submitted a proposed Interpretive Notice to NFA Compliance Rule 2-13 Concerning Presentation of Past Performance Information. Most of the proposals made in that submission have been incorporated in the CFTC's recent amendments to its Part 4 Rules, and, therefore, NFA hereby withdraws that submission. The treatment of pro forma and extracted performance results, however, was not included in the Part 4 Rule amendments. As these issues closely relate to the use of hypothetical performance results, NFA wishes to address these issues in the proposed Interpretive Notice contained herein.

The use of pro forma performance histories can present useful information to customers, particularly when used to show how the past performance of a given NFA Member or Associate would have been affected by the fee structure of the current offering. In other instances, however, the use of pro forma results carry some of the same limitations as hypothetical results. For example, some CPOs have used "pro forma" results to show what results a multi-advisor pool could have achieved in the past if the pool's assets had been allocated among certain CTAs in a certain proportion. This use of pro forma results reflects the same sort of hindsight analysis that hypothetical results do and invites the same sort of abuse. The Board would, therefore, not allow this particular use of pro forma results.

Hindsight analysis may also play a part in the presentation of "extracted performance" in which a Member selects one component of its overall past trading results to highlight to customers. In the Board's view, this use of extracted performance should be permitted only when the Member had previously designated the percentage of assets which would be committed toward that particular component of the overall trading program.

NFA respectfully requests that the Commission review and approve the proposals contained in this submission and requests that they be declared effective upon Commission approval.

Sincerely,

Daniel J. Roth
General Counsel

cc: Chairman Mary L. Schapiro
Commissioner Barbara Pedersen Holum
Commissioner Joseph P. Dial
Commissioner John E. Tull, Jr.
Andrea M. Corcoran, Esq.
Geoffrey Aronow, Esq.
Alan L. Seifert, Esq.
Susan C. Ervin, Esq.
Lawrence B. Patent, Esq.
David Van Wagner, Esq.

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nfa

NOTICE TO MEMBERS

NATIONAL FUTURES ASSOCIATION
NOTICE 1-95-12 • AUGUST 8, 1995

Please route to:

- ■ Compliance/Legal
- ☐ Registration
- ■ Sr. Management
- ☐ Finance
- ☐ Operations

Break-Even Analysis: Effective Date of Rule Amendment and Interpretive Notice

In 1994, NFA's Board of Directors ("Board") adopted amendments to NFA Compliance Rule 2-13 requiring the use of a break-even analysis in pool disclosure documents. The Board also adopted a formal interpretation of that requirement. The Commodity Futures Trading Commission ("CFTC") has recently notified NFA that it has approved the amendments to NFA Compliance Rule 2-13 and the Interpretive Notice adopted by the Board.

NFA Compliance Rule 2-13, as amended, and the Interpretive Notice adopted by the Board require each Member CPO which delivers a disclosure document under CFTC Regulation 4.21 to include a break-even analysis in the disclosure document. *The break-even analysis must include a tabular presentation of fees and expenses.* This requirement is intended to insure that customers will be clearly informed about both the nature and amount of fees and expenses they will incur and the impact of those fees and expenses on the potential profitability of the investment.

The Interpretive Notice adopted by the Board contains a sample break-even presentation. Members are reminded that the categories of fees and expenses specifically mentioned in the Interpretive Notice or included in the sample break-even presentation is not an exhaustive list. The analysis included in an actual disclosure document must include <u>all</u> of the fees and expenses of any type which affect the break-even point of that investment.

When pool participants are to receive some or all of the interest income generated by the pool, the expected interest income should be deducted from the expenses which must be covered by trading profits to return the customer to the level of his initial investment. The estimate of that interest income must include the assumed interest rate, and that rate must reflect current cash market information. When any interest income is to be paid to the pool operator, or to anyone other than the pool participants, that fact and an estimate of the amount must also be clearly disclosed.

The break-even analysis must be included in any disclosure document filed with the Commission and NFA on or after August 24, 1995, which is delivered to prospective participants under CFTC Regulation 4.21(a). Furthermore, as required by CFTC Regulation 4.21(e)(1), the break-even analysis must be updated in subsequent disclosure documents for open-end pools to reflect any changes in the information and to ensure that the break-even point is accurate as of the date of the disclosure document.

As amended, NFA Compliance Rule 2-13 reads as follows. A copy of the Interpretive Notice adopted by the Board is also attached.

COMPLIANCE RULES

***

Part 2 - RULES GOVERNING THE BUSINESS CONDUCT OF MEMBERS REGISTERED WITH THE COMMISSION

***

Rule 2-13. CPO/CTA REGULATIONS

(a) Any Member who violates any of CFTC Regulations 4.1 and 4.16 through 4.41 shall be deemed to have violated an NFA requirement.

(b) Each Member CPO which delivers or causes to be delivered a Disclosure Document under CFTC Regulation 4.21 must include in the Disclosure Document a break-even analysis which includes a tabular presentation of fees and expenses. The break-even analysis must be presented in the manner prescribed by NFA's Board of Directors.

(c) Each Member required to file any document with or give notice to the CFTC under CFTC Regulations 4.13 and 4.16 through 4.32 shall also file one copy of such document with or give such notice to NFA at its Chicago office no later than the date such document or notice is due to be filed with or given to the CFTC. Any CPO Member may file with NFA a request for an extension of time in which to file the annual report required by CFTC Regulation 4.22(c) or a request for approval of a change to its fiscal-year election by following the procedures set forth in NFA Financial Requirements Schedule E.

INTERPRETATION OF NFA COMPLIANCE RULE 2-13
BREAK-EVEN ANALYSIS

NFA Compliance Rule 2-13 requires, in pertinent part, that each Member CPO which delivers a disclosure document under the CFTC Regulation 4.21 must include in the disclosure document a break-even analysis which includes a tabular presentation of fees and expenses. The break-even analysis must be presented in the manner prescribed by NFA's Board of Directors. The purpose of this requirement is to ensure not only that customers will be clearly informed as to the nature and amount of fees and expenses that will be incurred, but that customers will also be made aware of the impact of those fees and expenses on the potential profitability of their investments. NFA's Board of Directors has adopted the following guidelines which must be adhered to by NFA Member CPOs when preparing the break-even analysis required by Compliance Rule 2-13:

- If fees are likely to be affected by the size of the offering, then an assumed amount of total funds raised should be stated. The document should also state what the break-even point would be if the minimum or maximum proceeds were raised.

- If there are redemption fees, they must be clearly shown and considered part of the total cost and reflected in the break-even analysis.

- Incentive fees should be stated as a percentage of profits, and the method by which profits are calculated should be described.

- All management, brokerage and other fees should reflect actual experience or contractual charges, if known. If not known, they should be based on good faith estimates. If, for example, CTAs publish their estimated number of round turns/ $1,000,000 then those published estimates should be used for estimating brokerage costs. If this is an on-going fund or if there is evidence supporting other numbers, then the other numbers should be used and explained.

To calculate the break-even point a CPO must first determine the amounts of all fees and expenses, exclusive of incentive fees, that are anticipated to be incurred by the pool during the first year of the investment. The total of these fees and expenses less the amount of interest income expected to be earned by the pool represents the gross trading profits before incentive fees (preliminary gross trading profits) that would be necessary for the pool to retain its initial Net Asset Value per unit at the end of the first year. In some situations the CPO must then calculate the additional trading profit that would be necessary to overcome the incentive fees that would be incurred. This situation will arise whenever the pool expects to incur expenses which would not be deducted from the CTA's net performance in calculating the CTA's incentive fee. That amount can be computed by first determining the incentive fees that would be incurred if the preliminary gross trading profits described above were achieved and then dividing that amount by (1- incentive fee rate); e.g., if the incentive fee is 25%, the denominator would be 1- .25, or .75. A sample break-even presentation is shown below:

Selling Price per Unit (1)	$ 1,000.00
Syndication and Selling Expense (1)	$ 50.00
General Partner's Management Fee (2)	9.50
Fund Operating Expenses (3)	20.50
Trading Advisor's and Trading Manager's Management Fees (4)	28.50
Trading Advisor's and Trading Manager's Incentive Fees on Trading Profits (5)	17.17
Brokerage Commissions and Trading Fees (6)	38.00
Less Interest Income (7)	(28.50)
Amount of Trading Income Required for the Fund's Net Asset Value per Unit (Redemption Value) at the End of One Year to Equal the Selling Price per Unit	$ 135.17
Percentage of Initial Selling Price per Unit	13.52%

Explanatory Notes:

(1) Investors will initially purchase units at $1,000. After the commencement of trading, units will be purchased at the Fund's month-end Net Asset Value per unit. A 5% syndication and selling charge will be deducted from each subscription to reimburse the Fund, the General Partner and/or the Clearing Broker for the syndication and selling expenses incurred on behalf of the Fund.

(2) Except as set forth in these explanatory notes, the illustration is predicated on the specific rates or fees contracted by the Fund with the General Partner, the Trading Manager, the Trading Advisor, and the Clearing Broker, as described in "Fees, Compensation and Expenses."

(3) The Fund's actual accounting, auditing, legal and other operating expenses will be borne by the Fund. These expenses are expected to amount to approximately 2.05% of the Fund's Net Asset Value.

(4) The Fund's Trading Advisor will be paid a monthly management fee of 1/2 of 2% of Allocated Net Assets. The fund's Trading Manager will be paid a monthly management fee of 1/12 of 1% of allocated Net Assets.

(5) The Trading Advisor and Trading Manager will receive incentive fees of 20% and 5%, respectively, of Trading Profits exclusive of interest income. The $17.17 of incentive fees shown above is equal to 25% of the net of total trading income of $135.17, minus $38.00 of brokerage commissions and trading fees and $28.50 of management fees.

(6) Brokerage commissions and trading fees are estimated at 4% of Net Asset Value.

(7) The Fund will earn interest on margin deposits with its Clearing Broker. Based on current interest rates, interest income is estimated at 3% of Net Asset Value.

U.S. COMMODITY FUTURES TRADING COMMISSION

Three Lafayette Centre
1155 21st Street, NW, Washington, DC 20581
Telephone: (202) 418-5000
Facsimile: (202) 418-5521

December 12, 1995

RECEIVED
GENERAL COUNSEL'S OFFICE

Mr. Daniel J. Roth
General Counsel
National Futures Association
200 West Madison Street
Chicago, Illinois 60606

Re: The National Futures Association's Proposed Amendment to Compliance Rule 2-29 and Proposed Interpretive Notice to Compliance Rule 2-29--Hypothetical Trading Results in Promotional Materials

Dear Mr. Roth:

By letters dated March 15, 1994, through September 21, 1995, the National Futures Association ("NFA") submitted to the Commission for its approval, pursuant to Section 17(j) of the Commodity Exchange Act ("Act"), a proposed amendment and interpretive notice to Compliance Rule 2-29. The proposed amendment and portions of the proposed interpretive notice would place certain restrictions on the use of hypothetical trading results in promotional materials.

Please be advised that on this date the Commission has determined to approve, pursuant to Section 17(j) of the Act, the proposed amendment to Compliance Rule 2-29 and the provisions of the proposed interpretive notice to Compliance Rule 2-29 which pertain to hypothetical trading results. As per the agreement of the NFA, the Commission will continue to consider the remaining provisions of the proposed interpretive notice to Compliance Rule 2-29 (i.e., the last two paragraphs of the notice) and their requirements for pro forma and extracted trading results.

Under recently-amended Commission Regulation 4.41, persons who present commodity interest hypothetical trading results in their promotional material must include in such materials either the disclaimer specified in Commission Regulation 4.41(b)(1)(i) or a disclaimer which complies with rules promulgated by a registered futures association pursuant to Section 17(j) of the Act. Accordingly, NFA should inform its members that while new NFA Compliance Rule 2-29(c)(4) would not require members to provide qualified eligible participants ("QEPs") with any disclaimer under Rule 2-29, members would be required to provide QEPs with a disclaimer pursuant to Commission Regulation 4.41(b)(1)(i).

Although the Commission's recent revisions to its Part 4 Regulations do not prohibit the use of hypothetical trading results in promotional materials, the Commission has continuing concerns as to the potential misleading nature of such results. Accordingly, NFA should report to the Commission within one year on whether its partial prohibition and its new disclaimer and disclosure of actual trading performance requirements are sufficient safeguards against the abuse of hypothetical trading results. Based upon these future experiences, the Commission could determine to prohibit or further restrain the use of such results. In such case, NFA would be required to make responsive changes to Compliance Rule 2-29 and its accompanying interpretive notice.

The Commission further reminds the NFA that it should review its sales practice audit procedures with respect to promotional materials to ensure that they adequately monitor compliance with NFA's new hypothetical trading results requirements.

Sincerely,

Jean A. Webb

Jean A. Webb
Secretary of the Commission

December 27, 1995

CFTC Approves Amendment to Rule 2-29 and Interpretive Notice Relating to Hypothetical Trading Results

A letter from the CFTC was received informing NFA that the Commission on December 12, 1995 approved NFA's proposed amendment to Compliance Rule 2-29 and the adoption of an interpretive notice to the rule, both relating to the use of promotional material containing hypothetical trading results. The rule amendment and the interpretive notice become effective on February 1, 1996.

Note: In its submission of the interpretive notice, NFA also proposed restrictions on the use of pro forma and extracted trading results. Those proposals are still under review by the CFTC and are not part of the interpretive notice which becomes effective on February 1.

U.S. COMMODITY FUTURES TRADING COMMISSION

Three Lafayette Centre
1155 21st Street, NW, Washington, DC 20581
Telephone: (202) 418-5430
Facsimile: (202) 418-5536

DIVISION OF
TRADING & MARKETS

April 25, 1997

Mr. Daniel J. Roth
General Counsel
National Futures Association
200 West Madison Street
Chicago, Illinois 60606

Re: Proposed Interpretive Notice to Compliance Rule 2-34--Nominal Account Size

Dear Mr. Roth:

By letters dated March 15, 1994, through June 2, 1995, the National Futures Association ("NFA") submitted to the Commission for its approval, pursuant to Section 17(j) of the Commodity Exchange Act ("Act"), a proposed interpretive notice to Compliance Rule 2-34 which would establish disclosure requirements for commodity pool operators ("CPOs") and commodity trading advisors("CTAs"). The proposal would require the use of the so-called notional funds method to establish nominal account size and present past performance in CPO and CTA disclosure documents.

The Commission believes that requiring such disclosure would necessitate either the amendment of its regulations or exemptive relief and has requested further information on how notional fund denominators are determined, especially for retail customers. The Commission needs such information to evaluate fully NFA's proposal. Based upon the request of Commission staff, NFA agreed last year to provide the Commission with more information on what methodologies CPOs and CTAs use to calculate nominal account sizes, including examples of their application. As of this date, NFA has not submitted such information to the Commission that sufficiently describes these methodologies for further evaluation.

Please inform the Division of Trading and Markets whether and when NFA plans to submit any additional information to the Commission, so that the Division can determine how to treat NFA's submission.

Very truly yours,

David P. Van Wagner
Special Counsel

NFA NATIONAL FUTURES ASSOCIATION
200 W. MADISON ST. • CHICAGO, IL • 60606-3447 • (312) 781-1300

February 26, 1998

Ms. Jean A. Webb
Secretariat
Commodity Futures Trading Commission
Three Lafayette Centre
1155 21st Street, N.W.
Washington, D.C. 20581

Re: National Futures Association: Proposed Deletion of NFA Compliance Rule 2-8(e)(2) and Proposed Amendments to NFA Compliance Rule 2-29(b)(5)

Dear Ms. Webb:

Pursuant to Section 17(j) of the Commodity Exchange Act, as amended, National Futures Association ("NFA") hereby submits to the Commodity Futures Trading Commission ("CFTC" or "Commission") the proposed deletion of NFA Compliance Rule 2-8(e)(2) and proposed amendments to NFA Compliance Rule 2-29(b)(5). The proposals contained herein were approved by NFA's Board of Directors ("Board") on February 19, 1998. NFA respectfully requests Commission review and approval of the proposals.

Proposed Amendments

A. <u>Proposed Deletion of NFA Compliance Rule 2-8(e)(2)</u> (Deletions are placed within brackets):

COMPLIANCE RULES

* * *

Part 2 – RULES GOVERNING THE BUSINESS CONDUCT OF MEMBERS REGISTERED WITH THE COMMISSION

* * *

RULE 2-8. DISCRETIONARY ACCOUNTS.

* * *

(e) **Third-Party Account Controllers.**

No Member FCM shall accept a customer account, and no Member FCM or IB shall introduce a customer account, over which a third party, not an Associate of such FCM or IB, is to exercise discretion without first obtaining[: (1) A] a copy of such account controller's written trading authorization or a written acknowledgment from the customer that such authorization has been given._[; and

(2) An acknowledgment from the customer that the customer has received a disclosure document from the account controller, or a written statement from the account controller explaining why the account controller is not required to provide a disclosure document to the customer.]

B) Proposed Amendment to NFA Compliance Rule 2-29(b)(5) (Additions are underscored):

COMPLIANCE RULES

* * *

RULE 2-29. COMMUNICATIONS WITH THE PUBLIC AND PROMOTIONAL MATERIAL

* * *

(b) Content of Promotional Material.

No Member or Associate shall use any promotional material which:

* * *

(5) includes any specific numerical or statistical information about the past performance of any actual accounts (including rate of return) unless such information is and can be demonstrated to NFA to be representative of the actual performance for the same time period of all reasonably comparable accounts and, in the case of rate of return figures, unless such figures are calculated in a manner consistent with

that required under CFTC Regulation 4.25(a)(7)(i)(F) <u>and are based on the nominal account size (as described in Compliance Rule 2-34)</u>.

Explanation of Proposed Amendments

A) <u>Explanation of Proposed Deletion of NFA Compliance Rule 2-8(e)(2)</u>

NFA Compliance Rule 2-8 provides certain requirements relating to a Member or Associate's exercise of discretion over a customer's commodity futures account. NFA Compliance Rule 2-8(e)(2) specifically provides that no FCM or IB Member shall accept or introduce a customer account over which a third party is to exercise discretion without first obtaining an acknowledgment that the customer has received a disclosure document or a written explanation why none was provided. Several FCM Members recently requested that NFA limit this requirement to apply only to unsophisticated customers.

Compliance Rule 2-8(e)(2) was originally developed by NFA's FCM Advisory Committee in 1984. At the time, that Committee stated that this provision was necessary, in part, based upon their belief that both the FCM carrying an account and a third party exercising discretion over an account have responsibilities to the customer. The FCM Advisory Committee reasoned that this provision's requirement would provide an additional check in the regulatory scheme to ensure that a person acting in a capacity requiring a disclosure document will not be able to place accounts at an FCM or IB without demonstrating that the document has been provided to the customer.

In evaluating the request to limit the application of Compliance Rule 2-8(e)(2), the Board noted that this provision essentially duplicates the protections afforded by NFA Bylaw 1101. To comply with Bylaw 1101, an FCM or IB Member must determine whether any third party trading a customer's account is a Member of NFA. If the account controller is a Member, the FCM or IB should be able to assume that the account controller has complied with NFA rules and has delivered any required disclosure documents. The Board reasoned that requiring the FCM or IB to obtain an acknowledgment from the customer that he has obtained the disclosure document adds little regulatory protection. If the account controller is not an NFA Member, Bylaw 1101 requires the FCM or IB to determine whether he is required to be registered. Thus, the current requirement in Compliance Rule

2-8(e)(2) that the FCM or IB obtain a written explanation from the account controller why a disclosure document was not required also adds little, if any, protection.

Therefore, the Board concluded that the regulatory protections afforded by Compliance Rule 2-8(e)(2) are essentially provided for by NFA Bylaw 1101 and, therefore, determined that NFA Compliance Rule 2-8(e)(2) should be deleted.

B) Explanation of Proposed Amendment to NFA Compliance Rule 2-29(b)(5)

As the Commission is aware, in 1995, NFA's Special Committee for the Review of CPO/CTA Disclosure Issues recommended and the Board approved a rule proposal to deal with the issue of notional funding. This issue stems from the simple fact that institutional customers direct a CTA to base its trading decisions on a certain amount the customer is willing to commit to a particular trading program. These customers, however, typically keep a much smaller amount on deposit with the FCM, usually their minimum margin requirement. The question becomes which figure the CTA should use as the beginning net asset value in computing rate of return—the amount the customer directed the CTA to use as the basis for its trading decisions or the amount the customer actually deposits with the FCM. NFA believes that CTAs should not have to reflect dramatically different rates of return for two customers making the same trades in the same trading program simply because the customers happen to have different cash management strategies.

NFA Compliance Rule 2-34 requires the CTA to disclose the partial funding of an account to the carrying FCM and to disclose to its customers how partial funding affects margins and fees. At the same time it approved Compliance Rule 2-34, the Board approved an interpretive notice to Compliance Rule 2-29 dealing with a number of issues concerning the content of disclosure documents. That notice included a statement that a CTA's "rate of return information must be calculated in a manner approved by the Commission and must be based on the entire amount of funds committed to trading (i.e., nominal account size)." Taken together, these two provisions were intended to require CTAs to calculate rate of return information on the amount a customer has committed to trading rather than on the actual funds in an account.

The Board subsequently withdrew the interpretive notice to Compliance Rule 2-29 since most of the issues it addressed have been superseded by changes to Commission rules. However, the Board did not amend Compliance Rule 2-34 or its interpretive notice at that time to include the requirement that rate of return be calculated based on the amount committed to trading. The Board has now amended NFA Compliance Rule 2-29(b)(5) to make that requirement explicit.

The amendment to Compliance Rule 2-29(b)(5) supplements NFA's March 15, 1995 submission regarding NFA Compliance Rule 2-34 and its accompanying interpretive notice. NFA will not make either proposal effective until both are approved by the Commission.

NFA respectfully requests that the Commission review and approve the proposed amendments referred to herein and requests that they be declared effective upon Commission approval.

Respectfully submitted,

Daniel J. Roth
General Counsel

DJR:ckm(sub\021998 Bd)

cc: Chairperson Brooksley Born
Commissioner Barbara Pedersen Holum
Commissioner John E. Tull, Jr.
Commissioner David D. Spears
Geoffrey Aronow, Esq.
I. Michael Greenberger, Esq.
Alan L. Seifert, Esq.
Lawrence B. Patent, Esq.
David Van Wagner, Esq.

NFA NATIONAL FUTURES ASSOCIATION
200 W. MADISON ST. • CHICAGO, IL • 60606-3447 • (312) 781-1300

February 25, 1999

By Overnight Mail

I. Michael Greenberger, Esq.
Director
Division of Trading and Markets
Commodity Futures Trading Commission
Three Lafayette Centre
1155 21st Street, N.W.
Washington, D.C. 20581

Re: Notional Funding

Dear Mr. Greenberger:

NFA's notional funding proposal has been pending at the Commission for almost five years and the underlying concept has been advocated by the industry for over a decade. NFA urges the Commission to separate NFA's proposal from the other issues discussed in the Commission's recent concept release on performance disclosure and to approve NFA's proposal quickly.

NFA understands and agrees with the Commission's concerns that partially funding accounts raises certain sales practice, disclosure, and financial responsibility issues. However, the Commission has attempted to deal with these concerns by regulating how CPOs and CTAs calculate their rate-of-return (ROR) rather than addressing the issues directly. By stretching the regulations regarding calculating ROR to deal with these concerns, the Commission has attacked the right problems with the wrong tools. As a result, the Commission's concerns have not been adequately addressed and ROR is unnecessarily distorted.

In theory and by definition, ROR is a measure of the CTA's performance. When actual funds on deposit with the FCM are used to calculate ROR, however, ROR becomes a measure of the client's gains or losses as a percent of the funds the client chose to deposit with the FCM, not a measure of the CTA's performance. For example, if two clients open accounts under a CTA's $250,000 trading program and begin trading at the same time, both accounts have the same commission and incentive fee structure, and both accounts receive identical trades, the CTA will generate the same absolute profits and losses for both accounts, regardless of funding level. The CTA did not do a better job for one account than for the other. If ROR is calculated based on actual funds on deposit, however, the ROR for the partially-funded account will be higher than that for the fully-funded account if the CTA made money and lower than that for the fully-funded account if the CTA lost money. This approach measures the clients' different cash-management strategies rather than the CTA's performance.

The Commission's approach also does not deal effectively with customer protection issues. Assume, for example, that a client has contracted with a CTA to participate in the CTA's $250,000 trading program but has only deposited $100,000 with the FCM. If the CTA uses the actual funds method of calculating ROR, the CTA is not required to provide any disclosure to the client about the effect of partial funding on margin calls, commissions, or leverage or to inform the FCM that the account is partially funded. If the CTA calculates ROR using the fully-funded subset method allowed under CFTC Advisory 93-13, on the other hand, this information will be provided to the client and the FCM, respectively. However, since the CTA is only required to provide funding information to the FCM if the account is partially funded, the FCM has no way of knowing if an account it does not receive funding information for is a fully-funded account or if it is really a partially-funded account that the CTA has failed to provide information on.

My staff has read each of the comment letters submitted in response to the concept release on performance disclosure, and we have discussed those comments with NFA's Special Committee on CPO/CTA Disclosure Issues (Special Committee). This letter discusses the Special Committee's response to the comments that address NFA's notional funding proposal. I am sending you a separate letter dealing with the issues raised in the concept release that are independent of the notional funding issue.

A. General Comments on the Use of Notional Funding

Several commenters were concerned that NFA's proposal will understate volatility and lead retail customers to believe that futures investments are safer than they really are. The Special Committee disagrees with this assessment. First, the Commission's rules require both the FCM or IB and the CTA to provide *risk disclosure* to managed account customers — disclosure that emphasizes that futures are very risky investments. Second, NFA's proposal supplements this disclosure for partially-funded accounts by requiring the CTA to inform the customer that the greater the disparity between the nominal account size and the amount deposited, the greater the likelihood and possible size of margin calls. Third, using the nominal account size in calculating ROR provides a more accurate picture of volatility than using actual funds on deposit does. If an account is being traded as a $250,000 account, it has the volatility of a $250,000 account, regardless of the amount of funds on deposit. The actual funds method, on the other hand, does not tell a client with a partially-funded account how **his** account will perform. The actual funds method overstates volatility by treating a

$250,000 account funded at $100,000 and a fully-funded $100,000 account as if they were the same; exaggerates profits and losses; creates widely divergent RORs for similarly traded accounts based solely on the clients' different cash management policies; and ignores the practical reality that both the CTA and the client consider the account size to be equivalent to the amount committed to trading rather than to the amount deposited for margin.

An academic commented that ROR should be based on the amount of "actual funds put at risk by the customer" and appears to believe that this amount is closer to actual funds on deposit than it is to nominal account size. As any customer who has ever received a margin call knows, however, the amount of funds deposited at the FCM does not represent the actual funds put at risk by the customer. Determining the amount of funds put at risk is an impossible task and would likely be closer to nominal account size than to actual funds on deposit.

This same commenter characterized nominal account sizes as hypothetical or fictitious amounts. As discussed elsewhere in this letter, NFA's proposal contains several safeguards to keep the nominal account size from being set at an arbitrary or "fictitious" level.

B. <u>Disclosure of Risk Profile Data on Partially-Funded CTA Programs</u>

The Commission's release asked for comments on "disclosure of risk profile data on CTA programs for clients considering participation on a partially-funded basis." In particular, the Commission asked whether CTAs should be required to present drawdown percentages based on two or three partial-funding levels offered by the CTA in addition to the fully-funded level.

In both a theoretical and a practical sense, partial funding does not affect risk. A $5,000 gain or loss is a $5,000 gain or loss regardless of whether it is 25% or 120% of the amount deposited at the FCM. Everyone in the same trading program has the same risk, regardless of funding level. What partial funding does affect is the percentage profit and loss based on the amount of funds deposited with the FCM — which neither the client nor the CTA considers to be the true account size — and the likelihood of margin calls. To the extent this raises a concern, NFA deals with it by requiring the CTA to disclose the effect of partial funding on the frequency and size of margin calls.

As you know, all commenters who addressed this issue opposed presenting drawdown percentages at different funding levels. Most commenters, including NFA, stated that the Commission's proposal is counter-productive in that it will confuse investors rather than enlighten them. Even if it were not confusing, disclosing drawdowns at different funding levels does not convey any useful information to the client since funding level does not affect either volatility or risk. Therefore, the Special Committee urges the Commission to abandon this proposal.

C. Presentation of Data Concerning Margin Rates

NFA's proposal requires a CTA who accepts a partially-funded account from a non-QEC to disclose "an estimated range of the amount of customer equity generally devoted to margin requirements or option premiums, expressed as a percentage of the nominal account size of the accounts traded by the CTA, and an explanation of the effect of partially funding an account at that percentage." We note that this requirement was not in NFA's original submission but was added to proposed Compliance Rule 2-34 in response to Commission staff's concerns about discipline in the denominator.

As you know, the notional funding debate revolves around what amount — agreed upon account size or actual funds on deposit — should be used as beginning net asset value (BNAV) in the denominator of the ROR calculation. One of the concerns raised by Commission staff is how to ensure that the account size is not a fictionalized amount created by the CTA after-the-fact solely to improve performance figures, understate volatility, or overstate the amount of funds under management. In other words, how do we provide "discipline in the denominator" so that the account size is based on the CTA's pre-designed trading program rather than being retro-fit to create particular performance and volatility figures?

The requirement to disclose a range of equity generally devoted to margin provides discipline in the denominator in two ways. First, all clients in the same trading program should have the same margin-to-equity ratio for the same nominal account size. Second, both the client and NFA (in an audit of the CTA) will know if the CTA varies significantly or regularly from the disclosed ratio in normal market conditions, which will cause NFA to question the validity of the account size used as BNAV.

In its concept release, the Commission characterized the proposed requirement as a measure of risk and asked whether using an estimated range of margin to equity is misleading. In response, one commenter suggested that disclosing a range of margin could be misleading for those CTAs that employ margin on a dynamic basis. Some commenters noted that unusual market conditions or significant increases in margin levels could cause a CTA to go outside the range of margin disclosed to its clients. Other commenters stated that disclosing the range of equity generally devoted to margin requirements is easy to comply with and provides some information about the degree of leverage being used. One commenter suggested that any required disclosure regarding margin levels be included in the advisory agreement rather than in the CTA's disclosure document. Although some commenters noted a very general relationship between margins and risk, the commenters universally took issue with the Commission's assumption that margins are a reliable measure of risk.

The Special Committee decided against amending proposed Compliance Rule 2-34 to eliminate the requirement that CTAs disclose a range of margin generally employed. First, as mentioned in NFA's comment letter, this requirement is not intended to be used as a measure of risk. Second, the rule does not dictate what document the disclosure must be made in, and a disclosure made in either the disclosure document or the client agreement will comply with the rule. Third, the rule requires the CTA to disclose the estimated range of equity generally devoted to margin requirements or options premiums. This range should be based on historical data from normal market conditions, and significant changes in exchange margin rates or unusual market events will not mean that the estimate does not comply with the rule.

The Commission's release also asked if "a requirement that CTAs commit to an absolute maximum percentage of customer equity devoted to margin, beyond which no margin-increasing changes will be made, provide[s] a more useful disclosure structure?" As stated in the comment letters, this suggestion is unworkable. The amount of margin required per contract is not within a CTA's control, and unusual market conditions or significant increases in margin levels could cause a CTA to go above a pre-disclosed maximum amount. Given this reality, the prudent thing for the CTA to do — as one commenter suggested — would be to set its maximum margin-to-equity ratio at 100%, and even that might not be high enough under extreme market conditions. Furthermore, if everyone selected a maximum margin-to-equity ratio of 100%, or even simply a margin-to-equity ratio designed to reflect unusual conditions rather than normal ones, the value of using the ratio to provide discipline in the denominator would be lost. Therefore, the Special Committee does not believe that NFA's proposal should be amended to require disclosure of a maximum margin level or that the Commission should impose such a requirement on its own.

D. Providing the CTA/Client Agreement to the FCM

NFA's proposal requires all CTAs to provide the FCM with a copy of a written agreement between the CTA and the client that states the nominal account size, identifies the trading program, states whether the account will be fully or partially funded, and describes how additions, withdrawals, profits, and losses will affect the nominal account size and the computation of fees. One purpose of this requirement is to increase the amount of information available to the FCM when assessing the creditworthiness of the client. The requirement also provides "discipline in the denominator" by assuring that the CTA and the client have agreed on the account size before the account is opened and begins trading rather than after-the-fact.

The Commission asked whether FCMs consider the nominal account size to be useful information. Although none of the comment letters came from FCMs, we note that none of the FCMs on the Special Committee or on our Board of Directors objected to receiving this information. Furthermore, one of the reasons we adopted the requirement was to address Commission staff's concerns about the financial integrity of the FCM carrying the partially-funded account. NFA's requirement provides the FCM with information about the size of the client's commitment to the trading program and its cash-management practices — information that could help the FCM in assessing the creditworthiness of the client and imposing credit limits on the client's account. We also note that this requirement is already imposed on partially-funded accounts under Commission Advisory 93-13.

One commenter suggested that Rule 2-34(a) should not apply to fully-funded accounts. The Special Committee's purpose in applying it to all accounts was to ensure that no partially-funded accounts fell through the cracks. Under CFTC Advisory 93-13, which requires funding information for partially-funded accounts only, an FCM has no way of knowing if an account that has not filed funding information is truly a fully-funded account or is really a partially-funded account that failed to file the required information. Under NFA's proposal, the FCM would know to ask for the funding information from any account that fails to file it. The Special Committee considered this comment and decided to retain the rule as submitted, thereby requiring CTAs to provide FCMs with funding information for all accounts.

The Commission also asked whether some other method of getting the information to the FCM might be more efficient. NFA is more concerned about achieving the purposes behind this requirement (i.e., providing information to the FCM and promoting "discipline in the denominator") than it is about the specific method for doing so. Therefore, NFA will interpret its requirement to give the CTA flexibility in how it implements the operational provisions of the rule.

For example, several commenters raised concerns that providing the advisory agreement to the FCM could result in the disclosure of proprietary information. The proposed rule does not specify, and the Special Committee did not intend, that the agreement required by Rule 2-34(a) must be included in the regular client agreement. Although the CTA can choose to include this information as part of its regular client agreement, the CTA can also choose to include it in a power of attorney form or in a separate document.

Proposed Rule 2-34(a) requires that the CTA disclose in writing "the factors considered by the CTA in determining any minimum account size of the trading program." One commenter stated that this determination often includes proprietary and discretionary information and asked that the proposal specify that only a general description is required. The proposed rule was not meant to require a detailed explanation that includes proprietary information. A general description is sufficient as long as it is meaningful rather than boilerplate. The Rule also does not require that this information be filed with the FCM.

This same commenter also questioned whether letters of commitment that comply with the terms of CFTC Advisory 87-2 would continue to be considered actual funds for purposes of deciding whether an account is fully funded. The Special Committee's proposal was not intended to change the types of instruments that can be used to fund an account. Letters of commitment would still be considered actual funds for purposes of determining whether an account is fully or partially funded and, therefore, whether the CTA must provide the disclosures required by proposed Rule 2-34(b).

E. <u>Presentation of Risk Profile Data on Commodity Pools</u>

NFA's proposal requires certain CPOs to provide pool participants with a statement of the total amount allocated to a pool's CTAs as a percentage of the pool's net assets. This information is only required for non-QEP pools that allocate assets among the pool's CTAs in such a way that the total allocations to its CTAs is greater than the total assets of the pool.

As with margin ranges, the Commission's release misunderstands and mischaracterizes NFA's purpose for requiring this information. The Commission states that "the most readily apparent use for NFA's proposed ratio would be for prospective clients to compare one commodity pool to another. On initial consideration, it might seem that the greater the amount of the nominal account size compared to pool net assets, the greater the risk of a pool would be." The Special Committee's purpose in adopting the disclosure requirement for certain pools was neither to promote comparability among pools nor to measure the pool's risk. The Special Committee's purpose was, quite simply, to require these pools to disclose the degree of leverage used by the particular pool — nothing more.

The Commission asked for comments on an alternative approach which would, essentially, require a pool to provide pro forma data based on the worst historical drawdown during the life of each of the vehicles (CTA programs or investee funds) the pool invested in over the course of the year times the number of days the pool invested in that vehicle during the year.

The commenters who addressed this issue did not oppose NFA's proposal. Most commenters did oppose the Commission's alternative approach, noting that the only relevant performance information is that of the pool itself. The Special Committee believes that NFA's proposal provides appropriate disclosure to potential and current pool participants and should not be supplemented by the Commission.

F. Theoretical Soundness of the Basis of Computation

As the Commission noted in its release, NFA's proposal does not require a CTA to maintain any fully-funded accounts. The Commission asked whether CTAs should be required to maintain a subset of fully-funded accounts to validate their nominal account sizes.

NFA's proposal is designed to validate nominal account sizes in three ways. First, the primary way to validate account size is to see if all accounts in the same trading program with the same nominal account size are traded the same way and have the same performance. Since all of these accounts use the same denominator for calculating ROR (i.e., nominal account size), it should be easy for NFA auditors to compare performance and to detect and question deviations — a comparison that is much more complex when each account's individual ROR is based on its own unique amount of funds on deposit. Second, proposed Compliance Rule 2-34 requires the CTA and the client to agree to the account size before the CTA starts trading the account. Third, NFA's proposal requires the CTA to disclose the range of equity expressed as a percentage of the nominal account size, and NFA will ask the CTA to justify any deviations not supported by unusual market activity or significant changes in margin amounts per contract. These three factors make NFA's proposal a superior instrument for validating nominal account sizes.

A number of commenters opposed the Commission's suggestion to require a fully-funded subset of accounts. These commenters noted that many CTAs do not have any fully-funded accounts and that the actual-funding level is not within the CTA's control. Other commenters suggested using the typical account size as the denominator for purposes of calculating ROR. One commenter suggested retaining the fully-funded-subset method but allowing CTAs who do not have any fully-funded accounts or do not meet the test for using it to calculate ROR based on NFA's proposal.

The Special Committee strongly objects to any requirement that CTAs maintain a fully-funded subset. As the commenters noted, many CTAs could not comply with that requirement in today's business environment, especially considering that CTAs cannot carry customer funds and, therefore, cannot effectively control the funding level. If it were easy to maintain and test for a fully-funded subset, the industry would have accepted the fully-funded subset method of calculating ROR rather than clamoring to use notional account sizes as the denominator in the ROR calculation, especially since both calculations yield the same result. As it is, however, NFA's proposal cannot co-exist with such a requirement.

NFA urges the Commission to separate NFA's proposal from the other issues addressed in the concept release and to approve NFA's proposal quickly. I look forward to discussing our proposal with you on March 3. If you have any questions in the meantime, please call me (312-781-1390), Dan Driscoll (312-781-1320), or Kathryn Camp (312-781-1393).

Very truly yours,

Daniel J. Roth/kpc

Daniel J. Roth
General Counsel

(kpc\Notional\Letter to Greenberger)

NFA NATIONAL FUTURES ASSOCIATION

January 2, 2004

Via Federal Express

Ms. Jean A. Webb
Secretariat
Commodity Futures Trading Commission
Three Lafayette Centre
1155 21st Street, N.W.
Washington, DC 20581

Re: National Futures Association: Resubmission of Proposed Adoption of NFA Compliance Rule 2-34 and its Interpretive Notice Concerning Performance Reporting and Disclosures, Resubmission of Proposed Amendments to Compliance Rule 2-29(b)(5) and Proposed Amendments to Compliance Rule 1-1.

Dear Ms. Webb:

NFA hereby withdraws its March 15, 1994 original submission and its March 15, 1995 resubmission of the proposed adoption of NFA Compliance Rule 2-34 and its March 15, 1995 submission of the proposed adoption of an interpretive notice to Compliance Rule 2-34 concerning Notional Funding. NFA also hereby withdraws its February 26, 1998 submission of proposed amendments to NFA Compliance Rule 2-29(b)(5). Pursuant to Section 17(j) of the Commodity Exchange Act, as amended, National Futures Association ("NFA") hereby resubmits to the Commodity Futures Trading Commission ("CFTC" or "Commission") the proposed adoption of NFA Compliance Rule 2-34 and its Interpretive Notice regarding Performance Reporting and Disclosures and proposed amendments to Compliance Rule 2-29(b)(5). NFA also submits proposed amendments to Compliance Rule 1-1. The proposals contained herein were approved by NFA's Board of Directors ("Board") on November 20, 2003.

NFA is invoking the "ten-day" provision of Section 17(j) of the Commodity Exchange Act ("CEA") and will make these proposals effective on May 1, 2004 unless the Commission notifies NFA that the Commission has determined to review the proposals for approval. NFA intends to notify its Members of these new requirements once the ten-day review period has passed in order to give them sufficient time to comply with the requirements.

200 West Madison Street Suite 1600 Chicago, Illinois 60606 312.781.1300 800.621.3570 312.781.1467 fax www.nfa.futures.org

PROPOSED AMENDMENTS

(additions are underscored and deletions are ~~stricken through~~)

COMPLIANCE RULES

* * *

PART 1 – DEFINITIONS

RULE 1-1. DEFINITIONS.

(a) **"Act"** – means the Commodity Exchange Act.

(b) **"Actual Funds"** – means the equity in a commodity trading account over which a CTA has trading authority and funds that can be transferred to that account without the client's consent to each transfer.

(c) **"Appeals Committee"** – means the Appeals Committee established under NFA Bylaw 702.

~~(c)~~(d) **"Associate"** – means a person who is associated with a Member within the meaning of the term "associated person" as used in the Act and Commission Rules and who is required to be registered as an "associated person" with the Commission.

~~(d)~~(e) **"Business Conduct Committee"** – means the Business Conduct Committee established under NFA Bylaw 704.

~~(e)~~(f) **"Commission" or "CFTC"** – means the Commodity Futures Trading Commission.

~~(f)~~(g) **"Commodity Pool Operator" or "CPO"** – means a person who is required to register or is registered as a commodity pool operator under the Act and Commission Rules.

~~(g)~~(h) **"Commodity Trading Advisor" or "CTA"** – means a person who is required to register or is registered as a commodity trading advisor under the Act and Commission Rules.

~~(h)~~(i) **"Contract Market"** – means an exchange designated by the Commission as a contract market in one or more commodities or licensed by the Commission for the trading of options.

~~(i)~~(j) **"Exchange Act"** – means the Securities Exchange Act of 1934.

~~(j)~~(k) **"Foreign Board of Trade"** – means a board of trade, exchange, or market located outside the United States, its territories or possessions.

~~(k)~~(l) **"Foreign Futures" and "Foreign Options"** – means futures and options transactions made or to be made on or subject to the rules of a foreign board of trade.

~~(l)~~(m) **"Foreign Futures or Foreign Options Customer"** – means any person located in the United States, its territories or possessions who trades in foreign futures or foreign options.

~~(m)~~(n) **"Futures"** includes—

(1) futures and option contracts traded on a contract market;

(2) option contracts granted by a person that has registered with the Commission under Section 4c(d) of the Act as a grantor of such option contracts or has notified the Commission under the Commission's rules that it is qualified to grant such option contracts;

(3) foreign futures and foreign options made or to be made on or subject to the rules of a foreign board of trade for or on behalf of foreign futures or foreign options customers as those terms are defined in the Commission's rules;

(4) leverage transactions as that term is defined in the Commission's rules; and

(5) security futures products, as that term is defined in Section 1a(32) of the Act.

~~(n)~~(o) **"Futures Commission Merchant" or "FCM"** – means a person who is required to register or is registered as a futures commission merchant under the Act and Commission Rules.

~~(o)~~(p) **"Hearing Committee"** – means the Hearing Committee established under NFA Bylaw 707.

~~(p)~~(q) **"Introducing Broker" or "IB"** – means a person who is required to register or is registered as an introducing broker under the Act and Commission Rules.

~~(q)~~(r) **"Leverage Transaction Merchant" or "LTM"** – means a person who is required to register or is registered as a leverage transaction merchant under the Act and Commission Rules.

~~(r)~~(s) **"Member"** – means a Member of NFA other than a contract market.

(t) **"Nominal Account Size"** – means the account size agreed to by the client that establishes the level of trading in the particular trading program.

(u) **"Partially-Funded Account"** – has the same meaning as in CFTC Regulation 4.10(m).

~~(s)~~(v) **"Person"** – includes individuals, corporations, limited liability companies, partnerships, trusts, associations and other entities.

(w) **"Qualified Eligible Person or QEP"** – has the same meaning as in CFTC Regulation 4.7(a).

~~(t)~~(x) **"Requirements"** – includes any duty, restriction, procedure or standard imposed by a charter, bylaw, rule, regulation, resolution or similar provision.

~~(u)~~(y) **"Security Futures Products"** – has the same meaning as in Section 1a(32) of the Act.

* * *

PART 2 – RULES GOVERNING THE BUSINESS CONDUCT OF MEMBERS REGISTERED WITH THE COMMISSION

* * *

RULE 2-29. COMMUNICATIONS WITH THE PUBLIC AND PROMOTIONAL MATERIAL

* * *

(b) Content of Promotional Material

No Member or Associate shall use any promotional material which:

* * *

(5) includes any specific numerical or statistical information about the past performance of any actual accounts (including rate of return)

(i) unless such information is and can be demonstrated to NFA to be representative of the actual performance for the same time period of all reasonably comparable accounts and,

(ii) in the case of rate of return figures, unless such figures are calculated in a manner consistent with ~~that required under~~ CFTC Regulation 4.25(a)(7)~~(i)(F)~~ for commodity pools and with CFTC Regulation 4.35(a)(6), as modified by NFA Compliance Rule 2-34(a), for figures based on separate accounts, or

* * *

NFA

RULE 2-34. CTA PERFORMANCE REPORTING AND DISCLOSURES

(a) Performance Information

(1) Member CTAs must calculate rate of return according to CFTC Regulation 4.35(a)(6) using nominal account size as the denominator.

(2) Draw-down information reported under CFTC Regulation 4.35(a)(1)(v) and (vi) must be based on rate of return figures using nominal account size as the denominator.

(3) In calculating net performance, Member CTAs may include interest earned on actual funds but may not impute interest on other funds.

(b) Written Confirmation for Partially-Funded Accounts

(1) For partially-funded accounts, a Member CTA must either receive from a client or deliver to a client a written confirmation that contains the following information:

(i) the name or description of the trading program, and

(ii) the nominal account size agreed to by the client and the CTA.

(2) For new clients, the written confirmation must be received from or delivered to the client before the CTA places the first trade for the client.

(3) For existing clients, the written confirmation must be received from or delivered to the client before the CTA places the first trade after any of the information required under Section (b)(1) of this rule changes. The written confirmation must include the new information and the effective date of the change but need not include any information that will remain the same.

(c) Additional Disclosures for Partially-Funded Accounts

CTAs must provide the following information to clients with partially-funded accounts if the clients are not QEPs:

(1) A statement of how management fees will be computed relative to the nominal account size,

(2) An explanation of how cash additions, cash withdrawals, and net performance will affect the nominal account size,

(3) A brief explanation regarding the effect of partial funding on margin and leverage,

(4) A statement that partial funding increases the fees and commissions as a percentage of actual funds but does not increase the dollar amount of those fees, and

(5) A description, by example or formula, of the effect of partial funding on rate of return and drawdown percentages.

(d) CPO Use of CTA Performance Information

Member CPOs who are required by CFTC Regulation 4.25(c) to disclose CTA performance must report the CTA performance on the same basis as the CTA is required to report it.

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INTERPRETIVE NOTICES

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COMPLIANCE RULE 2-34:
Performance Reporting and Disclosures

In July 2003, the Commodity Futures Trading Commission adopted a core principle for calculating rate of return (ROR) for partially-funded accounts. The Commission noted, however, that its core principle approach would not preclude NFA from developing more explicit guidance or performance standards.

NFA's Board of Directors believes that Member CTAs should use a uniform calculation to make it easier for clients to compare the performance of different CTAs. The Board also believes that ROR should be based on the amount that is the basis for the CTA's trading decisions so that ROR measures the CTA's true performance rather than its client's various cash management practices. Therefore, NFA's Board has adopted NFA Compliance Rule 2-34 to provide performance standards for Member CTAs and to require certain disclosures to ensure that clients understand the consequences of partially funding their accounts. The Board has also adopted this Interpretive Notice to provide additional guidance to CTA Members regarding performance reporting and disclosure.

CTAs will not be required to restate their previous performance, although they may choose to do so. As with any other information, however, a CTA must make any additional disclosures that are necessary to ensure that its performance record is not misleading.

Documenting the Nominal Account Size

The Board recognizes a client may elect to partially fund its account by depositing less funds with the FCM carrying its account than the client has directed the CTA trading the account to use as the basis for trading decisions. The Board believes that the nominal account size should be documented to provide "discipline in the denominator" by assuring that the client and the CTA have agreed on the account size before the account begins trading. This documentation will also provide an objective audit trail to verify past performance records.

Compliance Rule 2-34(b) requires the CTA to document the trading program and nominal account size for each client who partially funds its account by either receiving a written confirmation from or providing a written confirmation to the client with the required information. For example, the information could be included in the advisory agreement or delivered to the client as a separate document. Although NFA assumes that most CTAs will receive or provide this confirmation at the same time the CTA enters into an advisory agreement to direct or guide the client's account, NFA Compliance Rule 2-34(b) only requires that it occur before the CTA places the first trade.

The Rule does not require the CTA to get the client's written acknowledgement to a confirmation provided by the CTA, although the CTA may choose to do so. If the CTA does not require a written acknowledgement, the *confirmation should inform the client that the client must notify* the CTA, within a reasonable period specified in the confirmation, if the client does not agree with the terms included in the confirmation. The confirmation may be delivered in any manner consistent with CFTC requirements for delivery of account statements by commodity pool operators under CFTC Regulation 4.22(i).

Disclosure

Compliance Rule 2-34(c) requires CTAs to provide certain information to clients with partially-funded accounts if those clients are not QEPs. This information is designed to ensure that less sophisticated customers understand the effects of partial funding so that they can make informed decisions when funding their accounts.

Subsection (c)(2) requires the CTA to explain how each element of cash additions, cash withdrawals, and net performance will affect the nominal account size. If these items will not affect the nominal account size, the CTA may make an affirmative statement to that effect.

Under Compliance Rule 2-34(c)(5), the CTA must provide a description, by example or formula, of the effect of partial funding on ROR and drawdown percentages. A CTA may provide this information by example using a simple matrix showing the effect of partial funding at different funding levels. In the alternative, it may provide the client with the formula for converting ROR percentages based on the nominal account size to ROR percentages based on the partial funding level, e.g.:

(nominal account size / actual funds) * n = a

where n is the ROR percentage based on the nominal account size and a is the ROR percentage based on actual funds

This same formula may, of course, be used to convert any other information that is given as a percentage of the nominal account size, such as estimated commissions and fees.

The disclosures required by Compliance Rule 2-34(c) can be included in the CTA's disclosure document or the advisory agreement. They can also be provided in a separate document delivered to the client before the CTA places the first trade for the client.

Actual Funds

Compliance Rule 1-1(b) defines actual funds as the equity in a commodity trading account over which a CTA has trading authority and funds that can be transferred to that account without the client's consent to each transfer. Funds that are not in the trading account, often referred to as committed funds, qualify as actual funds only if they meet the following four tests:[1]

1. The ownership of the accounts must be identical;

2. The funds must be available for transfer (e.g., free credit balances that are not committed to another CTA's trading program);

3. The client must agree in writing that the FCM can transfer the funds to the managed account at the CTA's request; and

4. The CTA must be able to verify the amount of these funds.[2]

Materiality Standards

As a general rule, accounts in the same trading program will be included in the same composite performance capsule.[3] Since Compliance Rule 2-34(a) requires ROR to be calculated on nominal account size, the RORs for these accounts should be

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[1] These tests are derived from CFTC Advisory 87-2, [1986-1987 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 23,624 (June 2, 1987).

[2] Compliance Rule 2-34(a) provides that Member CTAs may include interest earned on actual funds but may not impute interest on other funds when calculating net performance. The CTA must be able to verify the amount of interest earned on the funds if the CTA includes that interest as part of its net performance.

[3] Accounts in the same trading program generally have the same pattern of trading.

materially the same. Accounts with materially different RORs should not, however, be included in the same performance capsule.[4]

Whether RORs are materially the same may vary depending on the circumstances. However, as long as the accounts are part of the same trading program, the following test provides a safe harbor for determining whether the accounts have materially the same ROR.[5]

- If the composite ROR including the account and the composite ROR excluding the account average 10 percent or more, they are materially the same if the difference between the two RORs is less than 10 percent of their average.

- If the composite ROR including the account and the composite ROR excluding the account average less than 10 percent and greater than 5 percent, they are materially the same if the absolute difference between the two RORs is no more than 1.5 percent.

- If the composite ROR including the account and the composite ROR excluding the account average 5 percent or less, they are materially the same if the absolute difference between the two RORs is no more than 1 percent.

The primary reason for this materiality test is to objectively demonstrate that each account included in the performance capsule is part of the same trading program. For that reason, the materiality test should use gross trading profits and losses rather than net performance. If a particular account in the capsule has a material effect on the capsule's net performance due to account-specific factors (e.g., commissions or interest), the CTA may continue to include that account in the capsule if

[4] Accounts that use different trading strategies should not be included in the same performance capsule even if their RORs are materially the same.

[5] This same materiality test can be used in other contexts. For example, NFA's interpretive notice entitled "NFA Compliance Rule 2-10: The Allocation of Bunched Orders for Multiple Accounts" (¶9029) requires CTAs to modify their allocation methods if accounts in the same trading program have materially different performance results. This is another instance where materiality would be measured using gross trading profits and losses.

it meets the materiality test using gross trading profits and losses.[6] However, the CTA should disclose the difference in net performance and identify the factors that are responsible for that difference.

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All performance information must be presented in a manner that is balanced and is not misleading. CTAs have an obligation to disclose all material information even if it is not specifically required by CFTC or NFA rules. Compliance Rule 2-34 and this Interpretive Notice do not relieve CTAs of that obligation.

EXPLANATION OF PROPOSED AMENDMENTS

On July 21, 2003, the Commission adopted a core principle approach to CTA performance reporting for partially-funded accounts. The core principle – which is codified in CFTC Rule 4.35(a)(7) – states that CTAs may present the performance of partially-funded accounts in any manner that is balanced and does not violate the antifraud provisions of the CEA or CFTC regulations. The preamble in the adopting release voices strong support for using the nominal account size when calculating ROR for partially-funded accounts, but the rule does not require it.

NFA and the industry believe that CTAs should use a uniform performance calculation so that clients can compare the performance of different managers and funds more easily. The July 21, 2003 release acknowledges these comments and states that the CFTC's core principle approach would not preclude the development of more explicit guidance or performance standards by self-regulatory organizations.

NFA's proposal provides uniform performance standards for Member CTAs and requires certain disclosures to ensure that clients understand the

[6] As with the test for material differences in trading results, whether the account has a material effect on net performance is determined by comparing the net performance of the composite with and without the account.

consequences of partially funding their accounts. This proposal was developed with the help of an informal subgroup of industry representatives.

Proposed NFA Compliance Rule 2-34 contains four sections. Section (a) requires CTAs to calculate ROR – including drawdown information – based on nominal account size. It also allows CTAs to include interest earned on actual funds in their performance calculations. An amendment to Compliance Rule 1-1 adds several definitions, including those for the terms "nominal account size" and "actual funds." In particular, "nominal account size" is defined as the account size agreed to by the client that establishes the level of trading in that program, and "actual funds" is defined as the equity in the account plus funds that can be transferred to the account without the client's consent to each transfer (known in the industry as "committed funds").

Section (b) of the proposed rule requires a written confirmation for each partially funded account. This confirmation must contain the name or description of the trading program and the nominal account size agreed to by the client and the CTA, and it must be updated whenever that information changes.

Section (c) of the proposed rule requires CTAs to provide certain disclosures designed to ensure that clients understand the consequences of partially funding their accounts. For example, among other items, CTAs must provide a description, by example or formula, of the effect of partial funding on rate of return and drawdown percentages. The disclosures do not have to be given to clients with fully-funded accounts or to qualified eligible persons.

The final section of the rule requires CPOs to report CTA performance on the same basis that the CTA is required to report it. This will ensure that the performance reported in a commodity pool disclosure document is the same as the performance reported in the CTA's disclosure document.

The proposed Interpretive Notice further explains the requirements in Compliance Rule 2-34. The four sections of the Interpretive Notice are summarized below.

- The section on "Documenting the Nominal Account Size" describes how the written confirmation can be given and provides the CTA with flexibility in complying with the confirmation requirement.

- The section on "Disclosure" provides examples of the type and manner of acceptable disclosure.

- The section on "Actual Funds" provides a test for determining whether funds that are not in the trading account will qualify as actual funds. This test is based on the test for "committed funds" in CFTC Advisory 87-2 and should allow the CFTC to rescind that Advisory.

- The section on "Materiality Standards" provides a materiality test for determining whether accounts can be included in the same performance capsule. This test is based on the materiality standards in CFTC Advisory 93-13 and a 1991 release regarding additions and withdrawals. As you are aware, the CFTC has already rescinded the 1991 release, and we believe that including the materiality test in NFA's Interpretive Notice should allow the CFTC to rescind Advisory 93-13 as well.

The introduction to the proposed Interpretive Notice states that CTAs will not be required to restate their previous performance. This means that they will not be required to recalculate performance that was calculated using one of the current methods. If the calculations produce significantly different results, however, the CTA should disclose the difference and explain the reason for it.

Compliance Rule 2-29(b)(5) has been amended to conform to the provisions of new Compliance Rule 2-34. Additionally, Compliance Rule 1-1 has been amended to add four new definitions.

NFA intends to implement NFA Compliance Rule 2-34 and its interpretive notice on the first day of the fourth month after the CFTC approves it or determines not to take review. This will give Members a minimum of three months to come into compliance. The confirmation requirements in NFA Compliance Rule 2-34(b) will apply to all existing accounts and the disclosure requirements in Compliance Rule 2-34(c) will apply to all accounts opened on or after the effective date of the rule. The performance requirements in NFA Compliance Rule 2-34(a) and (d) will be effective for all disclosure documents as of the effective date of the rule.

NFA

Ms. Jean A. Webb January 2, 2004

As mentioned earlier, NFA is invoking the "ten-day" provision of Section 17(j) of the Commodity Exchange Act and will make the proposals contained herein effective on May 1, 2004 unless the Commission notifies NFA that the Commission has determined to review the proposals for approval.

Respectfully submitted,

Thomas W. Sexton
Vice President and General Counsel

TWS:jac(m:/jac/SubmissionLtrs\Resubmission)

cc: Chairman James E. Newsome
Commissioner Barbara Pedersen Holum
Commissioner Sharon Brown-Hruska
Commissioner Walt Lukken
James L. Carley, Esq.
Gregory Mocek, Esq.
Patrick J. McCarty, Esq.
David Van Wagner, Esq.
Riva Spear Adriance, Esq.