

May 28, 1996

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 2-19 and Proposed Amendments to NFA  
Compliance Rules 2-8(b) and 2-29(c) and the  
Interpretive Notice Relating to the Use of Promotional  
Material Containing Hypothetical Performance Results

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" or "CFTC") proposed deletion of NFA Compliance Rule 2-19 and proposed amendments to NFA Compliance Rules 2-8(b) and 2-29(c) and the Interpretive Notice Relating to the Use of Promotional Material Containing Hypothetical Performance Results. The proposals contained herein were approved by NFA's Board of Directors on May 16, 1996. NFA respectfully requests Commission review and approval of the proposals.

**PROPOSED AMENDMENTS**

**A. Proposed Deletion of NFA Compliance Rule 2-19 In Its Entirety (deletions are bracketed):**

**COMPLIANCE RULES**

\* \* \*

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

\* \* \*



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**[RULE 2-19. OPTION DISCLOSURE AND OTHER REQUIREMENTS.]**

Each Member FCM or IB which engages in the offer or sale of commodity options traded on or subject to the rules of a contract market shall give immediate written notification to the Member's DSRO of any disciplinary action taken against the FCM, IB or any of its Associates by the Commission or by any other self-regulatory organization.]

- B. Proposed Amendment to NFA Compliance Rule 2-8(b) (additions are underscored and deletions are bracketed):

**COMPLIANCE RULES**

\* \* \*

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

\* \* \*

**RULE 2-8. DISCRETIONARY ACCOUNTS.**

\* \* \*

**(b) Review of Discretionary Trades.**

[Each commodity futures trade initiated by a Member or Associate thereof pursuant to the exercise of discretion must be identified as discretionary.]  
Except where specifically identified as an order for which discretion was not exercised, each commodity futures trade initiated in an account over which any Member or Associate, other than the person in whose name the account is carried, exercises trading authority or control shall be conclusively presumed to have been made pursuant to such trading authority or control. Each Member initiating such trades (other than a Member who employs only one individual having discretionary authority if that individual is also the only principal who supervises futures activity) must adopt and enforce written procedures:



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- (1) Which ensure that a partner, officer, director, branch office manager or supervisory employee of the Member (other than any individual who exercises discretion in trading the account) regularly reviews discretionary trading activity; and
- (2) Which require such partner, officer, director, branch office manager or supervisory employee to make a written record that such review procedures were performed.

\* \* \*

C. Proposed Amendments to NFA Compliance Rule 2-29(c) and its Interpretive Notice Relating to the Use of Promotional Material Containing Hypothetical Performance Results (additions are underscored and deletions are bracketed):

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

\* \* \*

(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:



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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 a hypothetical composite performance record showing what a multi-advisor account portfolio or pool could have achieved in the past if assets had been allocated among particular trading advisors must



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include in the promotional material the following disclaimer prescribed by NFA's Board of Directors instead of the disclaimer prescribed by Section (c)(1) of this Rule:

THIS COMPOSITE PERFORMANCE RECORD IS HYPOTHETICAL AND THESE TRADING ADVISORS HAVE NOT TRADED TOGETHER IN THE MANNER SHOWN IN THE COMPOSITE. HYPOTHETICAL PERFORMANCE RESULTS HAVE MANY INHERENT LIMITATIONS, SOME OF WHICH ARE DESCRIBED BELOW. NO REPRESENTATION IS BEING MADE THAT ANY MULTI-ADVISOR MANAGED ACCOUNT OR POOL WILL OR IS LIKELY TO ACHIEVE A COMPOSITE PERFORMANCE RECORD SIMILAR TO THAT SHOWN. IN FACT, THERE ARE FREQUENTLY SHARP DIFFERENCES BETWEEN A HYPOTHETICAL COMPOSITE PERFORMANCE RECORD AND THE ACTUAL RECORD SUBSEQUENTLY ACHIEVED.

ONE OF THE LIMITATIONS OF A HYPOTHETICAL COMPOSITE PERFORMANCE RECORD IS THAT DECISIONS RELATING TO THE SELECTION OF TRADING ADVISORS AND THE ALLOCATION OF ASSETS AMONG THOSE ADVISORS WERE MADE WITH THE BENEFIT OF HINDSIGHT BASED UPON THE HISTORICAL RATES OF RETURN OF THE SELECTED TRADING ADVISORS. THEREFORE, COMPOSITE PERFORMANCE RECORDS INVARIABLY SHOW POSITIVE RATES OF RETURN. ANOTHER INHERENT LIMITATION ON THESE RESULTS IS THAT THE ALLOCATION DECISIONS REFLECTED IN THE PERFORMANCE RECORD WERE NOT MADE UNDER ACTUAL MARKET CONDITIONS AND, THEREFORE, CANNOT COMPLETELY ACCOUNT FOR THE IMPACT OF FINANCIAL RISK IN ACTUAL TRADING. FURTHERMORE, THE COMPOSITE PERFORMANCE RECORD MAY BE DISTORTED BECAUSE THE ALLOCATION OF ASSETS CHANGES FROM TIME TO TIME AND THESE ADJUSTMENTS ARE NOT REFLECTED IN THE COMPOSITE.

If a Member or Associate has less than one year experience allocating assets among particular trading advisors, then the disclaimer must also contain the following statement:

(THE MEMBER) HAS HAD LITTLE OR NO EXPERIENCE ALLOCATING ASSETS AMONG PARTICULAR TRADING ADVISORS. BECAUSE THERE ARE NO ACTUAL ALLOCATIONS TO COMPARE TO THE PERFORMANCE RESULTS FROM THE HYPOTHETICAL



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ALLOCATION, CUSTOMERS SHOULD BE PARTICULARLY WARY  
OF PLACING UNDUE RELIANCE ON THESE RESULTS.

- [2] (3) 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;
  - (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] (4) 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 ¶ 9025.]
- [4] (5) 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 Regulation 4.7.

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**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



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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] Member 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





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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] and 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.

NFA's Board of Directors further notes that, as explained above, the preceding requirements also apply to a Member or Associate's use of promotional material containing a composite performance record showing what a multi-advisor managed account or pool could have achieved if the account's or pool's assets had been allocated among particular trading advisors. In the past, Members have often referred to these composite performance records as pro forma results; however, NFA's Board of Directors believes the pro forma label is misleading. Although the performance for each individual trading advisor is based upon actual results, the selection of and allocation among trading



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advisors has been done with the benefit of hindsight and, thus, the composite performance record is hypothetical in nature. Therefore, in addition to the preceding requirements, Members and Associates must appropriately label any composite performance record for a multi-advisor managed account or pool as hypothetical and not pro forma. Additionally, because the composite performance record is hypothetical in nature, Members must include a description of all the material assumptions noted above and, in this context, also describe the method used to select and allocate assets among particular trading advisors. The Board also notes that if a Member or Associate previously used promotional material containing hypothetical composite performance records for multi-advisor managed accounts or pools and the hypothetical results were substantially higher than the actual results subsequently obtained by the Member or Associate in allocating assets among the multi-advisors, then this fact must be disclosed in the promotional material.

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.

[Hindsight analysis may also play a part in the presentation of "extracted performance"] Addressing a different concern, the Board of Directors also believes that hindsight analysis may be misleading as applied to the presentation of



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"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.

[The use of pro forma and extracted results are two other areas in which a hindsight analysis can lead to misleading promotional material.] Lastly, 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.]

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**EXPLANATION OF PROPOSALS**

**A. Explanation of Proposed Deletion of NFA Compliance Rule 2-19**

In February 1996, the CFTC deleted CFTC Regulation 33.4(b)(6). Under the regulation, self-regulatory organizations had to require each member FCM to give notice to its designated self-regulatory organization of any disciplinary action taken against the FCM or any of its associated persons by the Commission or by another self-regulatory organization. NFA Compliance Rule 2-19 was adopted to comply with the requirements of the regulation. With the deletion of CFTC Regulation 33.4(b)(6), NFA Compliance Rule 2-19 is unnecessary and NFA proposes that it be deleted.

**B. Explanation of Proposed Amendments to NFA Compliance Rule 2-8(b)**

NFA Compliance Rule 2-8 contains requirements for Members or Associates exercising discretion over a customer's commodity futures account. In particular, NFA Compliance Rule 2-8(a) states, in pertinent part, that each Member must maintain records which clearly identify each account over which the Member or its Associate has discretionary authority. Additionally, NFA Compliance Rule 2-8(b) states, in pertinent part, that each commodity futures trade initiated by a Member or Associate pursuant to an exercise of discretion must be identified as discretionary.

The proposed amendment to Rule 2-8(b) takes a more presumptive position by providing that all trades initiated by a Member or Associate in a discretionary account will be conclusively presumed to be discretionary unless otherwise indicated.

**C. Explanation of Proposed Amendments to NFA Compliance Rule 2-29 and Its Interpretive Notice Relating to the Use of Promotional Material Containing Hypothetical Performance Results**

By letter dated September 21, 1995, NFA submitted for Commission review the Interpretive Notice Relating to the Use of



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Promotional Material Containing Hypothetical Performance Results ("Interpretive Notice"). The Commission subsequently approved the major portion of the Interpretive Notice but set aside for further consideration the proposed last two paragraphs of the Interpretive Notice dealing with restrictions on the use of pro forma and extracted trading results. The proposal set forth herein contains amendments to the portion of the Interpretive Notice that was approved by the Commission and it also revises and resubmits the last two paragraphs dealing with restrictions on the use of pro forma and extracted trading results.

As originally proposed, the Interpretive Notice permitted the use of pro forma results to adjust for commissions and fees as long as the results are not calculated in a misleading manner. However, the Interpretive Notice prohibited the use of results, often referred to as pro forma, which reflect a hindsight analysis, including the use of results showing what a multi-advisor account or pool could have achieved in the past if assets had been allocated among particular trading advisors in certain proportions.

Several NFA Members expressed concern that the Interpretive Notice may be too restrictive. Specifically, these Members questioned whether it was inconsistent to permit the use of hypothetical results while, at the same time, prohibiting the use of composite performance tables which show the results a multi-advisor account or pool could have achieved in the past if assets had been allocated among certain trading advisors. Upon reconsideration of the issue, the Board decided that these records, although often referred to as pro forma results, are really hypothetical in nature. The Board therefore determined to allow a Member to use these composite performance records subject to the same limitations relating to the use of hypothetical results.

The proposed amendment to NFA Compliance Rule 2-29(c) adopts a separate disclaimer, and the proposed amendment to the current Interpretive Notice makes clear that the stringent restrictions applicable to hypothetical results in general also apply to the use of hypothetical composite performance results. The Board determined that the proposed amendments address all regulatory concerns and, at the same time, satisfy the concerns raised by several NFA Members.



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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,

A handwritten signature in black ink, appearing to read "Daniel J. Roth", is written over the typed name.

Daniel J. Roth  
General Counsel

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

DJR:ckm (sub\051696)

**U.S. COMMODITY FUTURES TRADING COMMISSION**

Three Lafayette Centre  
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August 29, 1996

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

Re: National Futures Association's Proposed  
Amendments to Compliance Rules 2-8(b) and 2-  
29(c); Proposed Amendments to Interpretive  
Notice Relating to the Use of Promotional  
Material Containing Hypothetical Performance  
Results; and, Proposed Deletion of Compliance  
Rule 2-19

Dear Mr. Roth:

By letter dated May 28, 1996, and received May 31, 1996, the National Futures Association submitted to the Commission for its approval, pursuant to Section 17(j) of the Commodity Exchange Act ("Act"), the above-referenced proposed rule amendments and rule deletion.

Please be advised that on this date the Commission has determined to approve the above-referenced proposed rule amendments and rule deletion pursuant to Section 17(j) of the Act.

Sincerely,

*Jean A. Webb*  
Jean A. Webb  
Secretary of the Commission

