[¶ 25,942] CFTC Interpretative Letter No. 94-2. (Accrual of Fees Where Net Performance Is Reported Monthly and the Fees are Paid Quarterly.)

Commodity Futures Trading Commission. Division of Trading and Markets. January 22, 1994. Correspondence in full text.

Interpretations--CPOs--CTAs--Computation of Fees--Reporting.--Proper method for calculating and reporting incentive fees in a CTA's record of past performance included in a disclosure document explained.

See ¶ 7620, "Registration" division, Volume 1.

[CFTC Staff Reply]

This is in response to your request for an explanation of the proper method for calculating and reporting incentive fees in a commodity trading advisor's ("CTA") record of past performance, included in a disclosure document. The situation you presented was one where: the incentive fee to be paid is a percentage of net profits from the inception of the account; performance is presented in the CTA's performance table on a monthly basis, *i.e.*, the period used for financial reporting is monthly and fees are paid quarterly *after* the close of each calendar quarter.

Under Commission regulations, financial statements, including performance tables for CTAs and commodity pool operators ("CPOs"), as well as the annual financial statements and performance tables for commodity pools, must be prepared pursuant to generally accepted accounting principles ("GAAP"). The requirement that GAAP be followed is set forth in regulation 4.10(b), entitled "Net asset value", and regulation 4.22(a), entitled "Reporting to pool participants". The requirement that CPOs use GAAP in their financial statements is also applicable to CTAs, in that the regulation applicable to CTAs, regulation 4.31(a)(3)(ii), indicates that a CTA's performance tables must be prepared using the same information as required for commodity pools pursuant to regulation 4.21(a)(4)(ii)(A) through (F).

Under GAAP, revenues must be reported in the period in which they are earned, and expenses related to revenues, must be recorded and reflected as an expense in the same financial reporting period as the revenues to which they relate. If the expenses are not already otherwise recorded on the books in the appropriate time period, they must be accrued so that such expenses are recognized in the financial statements in the period in which the related revenues are earned. This is applicable regardless of whether the reporting period is monthly or quarterly, and the objective is to assure the reporting of accurate net performance (profit and loss) figures.

The incentive fee for each month is computed by multiplying the "applicable" net profits or losses by the incentive fee rate. Incentive fees are accrued only when *new* profits are earned, so that a fee is not paid twice on the same dollar of profits. Therefore, the "applicable" net profit figure for any month is determined by deducting the highest cumulative month-end profit figure ever achieved in prior months from the current month's cumulative profit amount. To the extent the current month's cumulative profit amount exceeds the highest of any of the prior months' cumulative profit amounts, there is an "applicable" net profit upon which a fee should be accrued. During any period where there is a loss, there will be a negative fee (negative expense) accrued, but only to the extent such negative fee constitutes a *reversal* of amounts previously accrued and unpaid. That is, when a loss is experienced in the second or third month of a quarter and there was a positive fee accrued in the first or second month of the quarter (which fees are unpaid, since payments are made quarterly), respectively, the amounts which were accrued during the first or second month should be reversed, based upon the incentive fee rate. This is necessary for a proper matching of revenues and expenses.

The attached example illustrates the computation of such an accrual and is intended to be representative of situations commonly encountered. Of course, the application of the attached example to other circumstances will depend upon all the facts and circumstances, including the rights and obligations contained in any legal agreements. Also, the principles set forth in the example would operate the same way using different time periods, such as where the fees are computed and paid based upon annual results, instead

of quarterly results. The primary objective to be achieved in all cases is to account for the economic substance of the transactions in accordance with GAAP and other Commission requirements.

If you have any further questions, please contact me at (202) 254-8955.
Sincerely, Paul H. Bjarnason, Jr., Chief Accountant.

EXAMPLE OF COMPUTATION OF INCENTIVE FEE ACCRUAL

This example is designed to present the computation of a CTA's incentive fee on a monthly basis, where the CTA's contract with his customer provides for the actual fee to be computed and paid on a quarterly basis. In this hypothetical example it is assumed an agreement provides for an incentive fee of 20% to be paid to the CTA based on quarterly "net new profits" ("NNP"). That is, this fee will be payable each quarter, in the first month following the end of the quarter, based upon the increase for the quarter in the amount by which cumulative profits from the inception of the account exceed cumulative losses since inception of the account. In other words the fee will not be paid twice on the same dollar amount of profits, such that, if there are losses during any quarter, the losses will have to be made up by profits in subsequent quarters, before any further incentive fees will be paid. However, once a quarterly fee is paid to the CTA, if there are subsequent losses, the prior payments of fees need not be refunded. Profit (loss), for purposes of calculating the incentive fee in this example, is defined as the net profit (loss) after deducting accrued commissions, and includes both realized profits and losses and changes in unrealized profits or losses during the accounting period. The method for making a monthly accrual under these terms is set forth below.

The objective of the computation is to derive NNP, which will be multiplied by the fee percentage to obtain the fee accrual for the month. NNP is computed by taking the amount by which the cumulative profits since inception ("CPSI"), if any, as of the current month-end, exceeds, the *highest* cumulative profits since inception, if any, *as of the prior month-end*. (Since the computation of this cumulative figure is somewhat complex, for emphasis, it is referred to herein as the *adjusted* highest cumulative profits ("AHCP").) In the simplest case, which is where profits are earned every month and there are no losses, the difference between CPSI and AHCP is, simply the amount of profits for the month. However, where there are losses in some months, the concepts and, hence, the computations are more complex.

CPSI is the cumulative profit or loss since inception and is derived by adding or deducting the profits and losses from inception, carrying the amount forward from month to month. The computation of AHCP is relatively simple when done on a quarterly basis, but is more involved when done on a monthly basis. The difference between the quarterly computation, which is the basis upon which the CTA is actually paid, and the monthly computation, which is the basis on which the performance table is presented in this case, is that the monthly computation can result in a negative fee amount, due to the reversal of fees accrued in the first or second months of that quarter. The fees which are reversed are only the ones which have not yet been paid to the CTA. There is no such reversal on a quarterly basis, since, once fees are paid to the CTA, the fees need not be refunded by the CTA if there are subsequent losses. However, subsequent losses must be made up by subsequent profits for any further fees to be paid to the CTA. This is explained in more detail in the following paragraph.

As already noted, one objective of this computation is to ensure that fees are not paid twice on the same cumulative dollar amount of profits. Therefore, AHCP from the prior month-end increases each month with the profits of the current month, but only *after* any prior losses since inception have been recovered. Conversely, AHCP will not increase during any month where losses of prior months have not been exceeded by the cumulative of the prior *and* current months' profits. AHCP related to profits on which a fee has already been paid (as opposed to being accrued and unpaid, as in the current quarter) will not be reversed, regardless of the extent of any current or future losses within any particular accounting period. However, AHCP which arose as a result of profits during the current quarter (because the fees have not yet been paid) are to be reversed based upon the losses for the month. For example, the accompanying table indicated that in the month of April a $4,000 fee was accrued because of a $20,000 profit that month. The month following, May, there was a $25,0000 loss, which led to a reversal of the $4,000 April accrual. The $4,000 April accrual

was reversed, because of the May loss and because it had not yet been paid to the CTA.[1] (Remember, payments are computed and made quarterly, after the close of the quarter so, the $4,000 April accrual was still unpaid in May.) Once NNP is computed, the fee accrual can be computed by multiplying NNP by the 20% incentive fee rate.

	Monthly Profit/ (Loss) (1)	Cum'l P/(L) Since Inception (CPSI) (2)	Adjusted Highest Cum'l Profits (AHCP) (3)	Net new Profits (NNP) * (4)	Accrual of Fee Expense (NNP x 0.2) (5)	Actual Cash Payments of Fees (6)	Bal of Accrued & Unpaid Fee @ End of Prior Mo. (7)	@ End of Current Mo. (8)
Jan	10,000	10,000	10,000	10,000	2,000	0	0	2,000
Feb	15,000	25,000	25,000	15,000	3,000	0	2,000	5,000
Mar	2,000	27,000	27,000	2,000	400	0	5,000	5,400
Apr	20,000	47,000	47,000	20,000	4,000	5,400	5,400	4,000
May	(25,000)	22,000	27,000***	(20,000)	(4,000)**	0	4,000	0
June	(12,000)	10,000	27,000	0	0	0	0	0
July	(20,000)	(10,000)	27,000	0	0	0	0	0
Aug	5,000	(5,000)	27,000	0	0	0	0	0
Sept	30,000	25,000	27,000	0	0	0	0	0
Oct	(25,000)	0	27,000	0	0	0	0	0
Nov	30,000	30,000	30,000	3,000	600	0	0	600
Dec	5,000	35,000	35,000	5,000	1,000	0	600	1,600
Jan	N/A	N/A	N/A	N/A	N/A	1,600	N/A	N/A

* NNP in any given month occurs only to the extent profits exceed losses on a cumulative basis from the inception of the account through the end of the given month. That is, for any given month NNP is the difference between CPSI for the given month and the AHCP as of the end of the prior month-end, *e.g.*, to compute the $20,000 amount for April, deduct the $27,000 amount for AHCP as of March 31 from the $47,000 amount for April 30. However, if CPSI minus AHCP results in a negative number, the amount actually entered in the NNP column may be negative *only* to the extent there is a reversal of increases in NNP occurring during the prior months of the same quarter. (For example, in May there was a $20,000 reversal of the April increase.)

** This is a reversal of the amount previously accrued. In all cases, negative accruals cannot exceed the balance of amounts previously accrued and unpaid.

*** The AHCP dropped to $27,000 in June. The $27,000 is the AHCP on which fees have previously been paid to the CTP and is what remains after a reversal of $20,000 in AHCP due to the losses in May. The fees which were accrued due to the April profits were unpaid as of May and could,

[1] However, hypothetically, had the $25,000 loss in May been incurred, instead in April, which is the first month of the quarter, there would have been no prior accrual to reverse and, hence, no negative accrual in April, *i.e.*, there would have been no fee accrued in April. Also, following a hypothetical $20,000 loss in April (for which no negative accrual would be possible), were there a $20,000 profit in May, there would be no fee accrual in May on that $20,000 profit, because any such May profit would be merely making up for the April loss.

therefore, be reversed in connection with the May loss. (Remember, fees which have been paid already need not be refunded by the CTA due to losses and, hence, cannot be reversed.) The June loss of $12,000 gave rise to no negative accrual, because there was no unpaid accrued fee to reverse.

General:

In the example incentive fees were accrued for each month in the first quarter shown because the account had a net trading profit each month. Cumulative quarterly trading profits for the first quarter were $27,000.

In April, the first month of the second quarter, incentive fees were also accrued because cumulative quarterly trading profits were $20,000 and there were no trading losses from the previous quarter to carry forward. In May, a trading loss for the month of $25,000 changed the cumulative quarterly gain to a loss of $5,000 ($20,000 gain from April combined with a $25,000 loss for May), so no incentive fee was accrued for that month's statement. Additionally, the $4,000 accrual made in April needed to be reversed because, at the end of May, cumulative profits had changed to a cumulative loss. Note that the amount of the reversal can never exceed the sum of the accruals made in previous month of the quarter. In June, the pool again had a trading loss and the cumulative loss, as measured since the end of March (the last month following which an accrued fee was paid), became $17,000 (cumulative loss as of the end of May of $5,000, plus the additional loss for June of $12,000), so no incentive fee was accrued for that month, or payable for the quarter.

In the third quarter (July through September), no monthly accruals were made because there was a trading loss in July and trading profits in August and September were not sufficiently high enough to negate the cumulative losses carried forward in order to create a positive NNP.

In the final quarter of the year, an accrual was not made in October because there was a trading loss, which increased the loss carried forward since March to $27,000. An incentive fee accrual of $600 (0.2 x $3,000 of net new trading profit.) was made in November because the trading profit exceeded the cumulative losses carried forward ($27,000 of cumulative losses carried forward from October combined with profits of $30,000 for November). An additional accrual was made in December because cumulative net new trading profits rose by $5,000 (0.2 x $5,000 = $1,000). At the end of this quarter, the total accrued incentive fee was $1,600 (to be paid in January).