

August 29, 2019

**Via Federal Express and E-mail (Ckirkpatrick@cftc.gov)**

Mr. Christopher J. Kirkpatrick  
Secretary  
Office of the Secretariat  
Commodity Futures Trading Commission  
Three Lafayette Centre  
1155 21st Street, N.W.  
Washington, DC 20581

Re: National Futures Association: Proposed Amendments to NFA Interpretive Notice Entitled: *Compliance Rule 2-13: Break-Even Analysis*, NFA Compliance Rule 2-34 and the Interpretive Notice Entitled: *Compliance Rule 2-34: Performance Reporting and Disclosures*

Dear Mr. Kirkpatrick:

Pursuant to Section 17(j) of the Commodity Exchange Act ("CEA" or "Act"), as amended, National Futures Association ("NFA") hereby submits to the Commodity Futures Trading Commission ("CFTC" or "Commission") the proposed amendments to the NFA Interpretive Notice entitled *Compliance Rule 2-13: Break-Even Analysis*, the proposed amendments to NFA Compliance Rule 2-34 as well as the proposed amendments to the NFA Interpretive Notice entitled *NFA Compliance Rule 2-34: Performance Reporting and Disclosures*. NFA's Board of Directors ("Board") unanimously approved the proposed amendments at its meeting on August 15, 2019.

NFA is invoking the "ten-day" provision of Section 17(j) of the CEA and plans to issue a Notice to Members establishing an effective date for this proposal as early as ten days after receipt of this submission by the Commission unless NFA is notified that the Commission has determined to review the proposal for approval.

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**PROPOSED AMENDMENTS**  
**(additions are underscored and deletions are ~~stricken through~~)**

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**INTERPRETIVE NOTICES**

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**9023 – 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~~ participants will be clearly informed as to the nature and amount of fees and expenses that will be incurred, but that ~~customers~~ participants 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:

- The break-even analysis must include the applicable fees and expenses required to be described in the CPO's disclosure document by CFTC Regulation 4.24(i).
- ~~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. The break-even analysis must be based on the minimum initial investment amount for a participant and the minimum total subscription amount required for the pool to commence trading. Additionally, if the CPO anticipates a higher amount of total funds raised that will affect the fees and expenses per participant, then the CPO may also provide a break-even analysis using the higher amount of anticipated total funds raised.~~
- ~~If there are a redemption fees is charged at the end of the first year of investment, they it must be clearly shown, and considered part of the total cost and reflected in the break-even analysis. Any other redemption fee(s) (e.g., early withdrawal fees) on the redemption of the initial investment must be disclosed in the explanatory notes to the break-even analysis.~~
- If the pool incurs fees and expenses in connection with the pool's participation in other investments, such fees or expenses must be clearly shown, considered part of the total cost and reflected in the break-even analysis.
- ~~Incentive fees should must be stated as a percentage of profits, and the method by which profits are calculated should must be described.~~
- ~~All management, brokerage and other fees should must reflect actual experience or contractual charges, if known. If not known, they should must 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.~~

- ~~If 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. For purposes of the break-even analysis, CPOs may only offset expenses with interest income generated through the pool's investment in high credit quality short-duration<sup>1</sup> instruments or deposits associated with the pool's buy-and-hold cash management strategies. Examples of such instruments or investments include, but are not limited to, Treasury Bills, cash on deposit at a bank or in a money market account, funds on deposit with brokerage firms and interest in a money market mutual fund. The estimate of that this interest income must include the assumed interest rate, and that rate must reflect current cash market information. If 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.~~

~~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 tThe CPO must then calculate the additional trading profit that would be necessary to overcome the any incentive fees that would be incurred: by a participant prior to the participant recovering the amount of their initial investment. This situation will arise whenever the pool expects to incur expenses which would not be deducted from the CTA's net performance that is the basis of in-calculating the CTA's incentive fee calculation. ~~That~~ The incentive fee amount can be computed by first determining summing the incentive fees that would be incurred if the preliminary gross trading profits described above were achieved all of the pool fees, expenses and interest income that will be excluded from the computation of the incentive fee, and then dividing that amount by (1- incentive fee rate) and then multiplying this amount by the incentive fee rate; (e.g., For example, if the incentive fee is 25% percent, the denominator would be (1- .25, or .75) multiplied by the incentive fee rate of 25%.~~

As discussed above, the break-even presentation should be based on the minimum initial investment amount and the minimum total subscription amount required for the pool to commence trading. A sample break-even presentation is shown below:

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<sup>1</sup> For the purpose of this Interpretive Notice, short-duration generally means instruments with a term of one year or less.

|  |                                      |
|--|--------------------------------------|
| <del>Selling Price per Unit</del> <u>Minimum Initial Investment</u> (1)  | <del>\$1,000.00</del> <u>100,000</u> |
| <u>Upfront</u> Syndication and Selling Expense (4 <del>2</del> )   | <del>\$50.00</del> <u>\$1,500</u>    |
| <u>Initial Organizational Expenses</u> (3)   | <u>200</u>                           |
| General Partner's Management Fee (2 <del>4</del> )   | <del>9.50</del> <u>985</u>           |
| Fund Operating Expenses (3 <del>5</del> )  | <del>20.50</del> <u>1,034</u>        |
| Trading Advisor's and <del>Trading Manager's</del> Management Fees (4 <del>6</del> )   | <del>28.50</del> <u>1,773</u>        |
| Trading Advisor's and <del>Trading Manager's</del> Incentive Fees on Trading Profits (5 <del>7</del> )   | <del>17.17</del> <u>439</u>          |
| <u>The General Partner's Incentive Fees on Trading Profits</u> (8)   | <u>0</u>                             |
| Brokerage Commissions and Trading Fees (6 <del>9</del> )   | <del>38.00</del> <u>1,724</u>        |
| Less Interest Income (7 <del>10</del> )  | <del>(28.50)</del> <u>(1,231)</u>    |
| Amount of Trading Income <u>Profits</u> Required for a Participant's Capital Account <del>the Fund's Net Asset Value Per Unit</del> (Redemption Value) at the End of One Year to Equal <del>the Selling Price per Unit</del> <u>Its Initial Investment</u> | <del>\$135.17</del> <u>6,424</u>     |
| Percentage of <u>Minimum</u> Initial <del>Selling Price per Unit</del> <u>Investment</u>   | <del>13.52%</del> <u>6.42%</u>       |

**Explanatory Notes:**

(1) ~~Investors will initially purchase units at \$1,000 make an investment of \$100,000. After the commencement of trading, units will be purchased at the Fund's month-end Net Asset Value per unit. The break-even presentation is based on the \$100,000 minimum initial investment and the minimum total subscriptions of \$5,000,000 for the Fund to commence trading.~~

(2) ~~A 1.5% five percent~~ upfront 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~~3~~) ~~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." The initial organizational costs for the Fund are \$10,000. Therefore, each participant's allocation of those costs based on a minimum initial investment of \$100,000 and minimum total subscriptions of \$5,000,000 will be \$200.~~

(4) The Fund's General Partner will be paid a monthly management fee of 1/12 of 1% of Net Asset Value.

(35) 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~~1.05% percent of the Fund's Net Asset Value.

(46) The Fund's Trading Advisor will be paid a monthly management fee of 1/12 of ~~two percent~~ 2% of Allocated Net Assets, which is anticipated to be 90% of the Net Asset Value. ~~The fund's Trading Manager will be paid a monthly management fee of 1/12 of one percent of allocated Net Assets.~~

(57) The Trading Advisor ~~and Trading Manager~~ will receive an incentive fees of ~~20 percent~~ 15% and ~~five percent~~, respectively, of Trading Profits exclusive of interest income. The ~~\$439~~ 47.17 of incentive fees shown above is equal to ~~25 percent~~ 15% of the net of total trading income of ~~\$6,424~~ 435.17, minus ~~\$1,724~~ 38 of brokerage commissions and trading fees and ~~\$1,773~~ 28.50 of Trading Advisor management fees.

(8) In the above example, no incentive fee for the General Partner is included in the calculation. The General Partner charges a 20% quarterly incentive fee based upon New Net High Profits. New Net High Profits is the net of all management fees, brokerage commissions and operating expenses and as such, the General Partner does not receive an incentive fee until the Fund generates trading income sufficient to offset such expenses. Based on the above analysis, the General Partner would need to earn more than \$6,424 of gross trading income per unit before it would be entitled to an incentive fee.

(69) Brokerage commissions (including any spread on forex transactions) and trading fees are estimated at ~~four percent~~ 1.75% of Net Asset Value.

(710) The Fund will earn interest on margin deposits with its Clearing Broker. Based on a current assumed interest rates of 2%, interest income is estimated at ~~three percent~~ 1.25% of Net Asset Value.

The above break-even analysis is a sample and the fees and expenses included in it may vary from those charged by other commodity pools. The analysis included in an actual disclosure document must include **all** of the fees and expenses of any type which affect the break-even point of that investment.

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## COMPLIANCE RULES

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

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#### **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 (see NFA Compliance Rule 1-1(x)) 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~~ with Actual Funds that Differ from the Nominal Account Size**

(1) For ~~partially-funded accounts~~ with actual funds (see NFA Compliance Rule 1-1(b)) that differ from the nominal account size (i.e., partially-funded accounts and accounts with funds that exceed the nominal account size), 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; ~~and~~

(iii) an explanation of how cash additions, cash withdrawals and net performance will affect the nominal account size.

(2) ~~For new clients, the~~ A 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~~ If any of the information required under Section (b)(1) of this rule changes; ~~The~~ a 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 describing

the change and the effective date of the change must be received from or delivered to the client before the CTA places another trade for the client.

**(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,~~ A statement that partial funding increases leverage and may result in more frequent and larger margin calls;
- (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 draw-down 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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**9054 – COMPLIANCE RULE 2-34: CTA 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.~~

## **I. Introduction**

NFA's Board of Directors (Board) 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 rate of return (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 ~~regardless of 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~~ clients that explain the consequences effect 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 requirements for accounts with actual funds that differ from nominal account size, as well as to provide additional performance presentation guidance.

~~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.~~

## **II. Accounts with Actual Funds that Differ from the Nominal Account Size Documenting Written Confirmation for Accounts with Actual Funds that Differ from 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. A client may also choose to fund or maintain its account with an amount in excess of the amount the client has directed the CTA to use as the basis for trading decisions. The amount of equity in the client's commodity trading account plus any funds that can be transferred to that account without the client's consent to each transfer is known as actual funds (see NFA Compliance Rule 1-1(b)). The amount of funds agreed to by the client that establishes the level of trading engaged in by the CTA is known as the nominal account size (see NFA Compliance Rule 1-1(x)).<sup>1</sup> The Board believes that the nominal account size should be documented to provide "discipline in the denominator" by ~~assuring~~ ensuring 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 and the effect of cash additions, cash withdrawals and net performance on nominal account size for each client ~~who partially funds its account with actual funds that differ from the nominal account size~~ by either receiving a written confirmation from or providing a written confirmation to the client with ~~the~~ this required information prior to the time the CTA places the first trade for the client.<sup>2</sup> ~~For example, if the CTA is providing the written confirmation, the information could~~ may 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 as long as the written confirmation is provided to the client before the CTA places the first trade for that client. If any changes are made to the client's trading program, nominal account size or the way in which cash additions, cash withdrawals or net performance affect nominal account size, a written confirmation describing these changes must be provided to or received from the client prior to the CTA placing any new trades for the client. In the absence of a written confirmation designating a nominal account size, performance returns must be based upon the amount of actual funds.~~

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).

### **Additional Disclosure for Partially-Funded Accounts**

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~~ These additional disclosures are designed to ensure that less sophisticated customers understand provide information to clients on the effects of partial funding on net performance, fees, margin and leverage 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 Subsection 2-34(c)(54), requires the CTAs must to provide a description, by example or formula, of the effect of partial funding on ROR and draw-down percentages. A CTA may provide this information by example using a simple matrix showing the effect of partial funding at different funding levels as illustrated by the following matrix:-~~

**Rates of Return Based On Various Funding Levels**

| Actual Rate of Return | Level of Funding |         |         |         |
|-----------------------|------------------|---------|---------|---------|
|                       | 100.00%          | 75.00%  | 66.67%  | 50.00%  |
| -40.00%               | -40.00%          | -53.33% | -60.00% | -80.00% |
| -30.00%               | -30.00%          | -40.00% | -45.00% | -60.00% |
| -20.00%               | -20.00%          | -26.67% | -30.00% | -40.00% |
| -10.00%               | -10.00%          | -13.33% | -15.00% | -20.00% |
| 00.00%                | 00.00%           | 00.00%  | 00.00%  | 00.00%  |
| 10.00%                | 10.00%           | 13.33%  | 15.00%  | 20.00%  |
| 20.00%                | 20.00%           | 26.67%  | 30.00%  | 40.00%  |
| 30.00%                | 30.00%           | 40.00%  | 45.00%  | 60.00%  |
| 40.00%                | 40.00%           | 53.33%  | 60.00%  | 80.00%  |

In the alternative, if a CTA may provide the client with the following formula, which for converting ROR percentages based on the nominal account size to ROR percentages based on the partial funding level, e.g:

$$(\text{nominal account size} / \text{actual funds}) * n = a$$

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.

### **III. Other Performance Reporting Guidance**

#### **Actual Funds**

Rule 2-34(a)(3) provides that CTAs may include earned interest on actual funds in calculating net performance but may not impute interest on other 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:<sup>4</sup>

1. The ownership of the trading accounts and any other accounts holding funds available to the CTA for trading must be identical;

2. The funds must be available for transfer to the client's trading account (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~~ may transfer the funds to the client's managed account at the CTA's request; and
4. The CTA must be able to verify the amount of these funds.<sup>23</sup>

### **Materiality Standards Composite Performance Reporting**

~~As a general rule, accounts in the same trading program will be included in the same composite performance capsule.<sup>3</sup> Since Compliance Rule 2-34(a) requires ROR to be calculated on nominal account size, the RORs for these accounts should be materially the same. Accounts with materially different RORs should not, however, be included in the same performance capsule.<sup>4</sup>~~

Compliance Rule 2-34(a) requires RORs to be calculated on nominal account size. As a general rule, accounts in the same trading program should have materially the same ROR and should be included in the same composite performance capsule.<sup>4</sup> Accounts that have similar RORs but are traded differently are not considered to be in the same trading program and may not be included in the same composite performance capsule.

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 that are part of the same trading program that meet the requirements of the following test generally will be considered to have materially the same ROR.:<sup>5</sup>

- 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 it meets the materiality test using gross trading profits and losses.<sup>6</sup> However, the CTA should

disclose the difference in net performance and identify the factors that are responsible for that difference.

There may be instances in which a population of the accounts included in a CTA's composite performance capsule appear on their face to meet one of the materiality tests described above on an account by account basis, but due to material differences in the nominal size of these accounts they serve to distort the overall performance of the composite. As a result, the ROR of the composite performance is not representative of the actual ROR experienced by a majority of the other accounts. In such instances, the population of accounts with nominal sizes that materially differ from the nominal size of the majority of the accounts should be composited separately.

### **Additions and Withdrawals**

Large additions and withdrawals during the reporting period may distort ROR. ~~A CTA is not required to adjust its ROR calculation unless those additions and withdrawals have a material effect on ROR under the above test.<sup>7</sup>~~ If they do have a material effect, however, the CTA must use an approved method to minimize the distortion. Appendix B ~~to Part 4 of the CFTC's Regulations~~ Part 4 Rules describes two methods that CTAs ~~can~~ may use to adjust for additions and withdrawals when calculating ROR: the compounded rate of return method and the time-weighted method. These methods are available to all CTAs under the terms described in Appendix B of Part 4 of the CFTC's Regulations.

CTAs may also use a third method – the only accounts traded (OAT) method – that adjusts for additions and withdrawals by temporarily excluding certain accounts when calculating ROR.<sup>86</sup> This method can be used if the following conditions are met:

1. As with any performance information, all of the accounts ~~– whether included in or excluded from the ROR calculation –~~ are part of the same trading program;
2. Excluding the accounts does not result in the systematic exclusion of any material costs (e.g., accounts with withdrawals or that are closed during the reporting period must be included in ROR if there is a significant exit fee that is only charged when funds are withdrawn or accounts are closed);
3. Only accounts that meet one of the following requirements are excluded:
  - The account was opened during the reporting period,
  - The account was closed during the reporting period,
  - The account had no open positions and did not trade during the reporting period because it has not yet been approved for trading or because during the reporting

period the client intended to ~~and did~~ close the account and then closed the account shortly after the reporting period ended,<sup>97</sup> or

- The net additions and withdrawals in the account exceeded 10% of the beginning net nominal account value for the period for that individual account;
4. Use of this method does not produce an ROR that is materially different from the ROR expected to be produced by either the compounded rate of return method or the time-weighted method over time; and
5. The method does not exclude a significant percentage of the accounts in the trading program.

In general, the CTA should use one method consistently provided that it results in an ROR calculation that accurately and reasonably represents the ROR. The CTA should use this method except where ~~that~~ the method would produce results that are materially different from the actual experience of accounts in the trading program,<sup>108</sup> in which case the CTA should use one of the other methods described above that better reflects the actual experience of accounts in the trading program. The CTA ~~should~~ must disclose the method that is consistently used and, if the CTA uses a different method for a particular reporting period, the CTA ~~should~~ must disclose the method actually used for that reporting period and describe why that method was used.<sup>119</sup>

CTAs may use any of these three methods without obtaining prior approval from NFA or the CFTC. Pursuant to Appendix B to Part 4 states that "a commodity pool operator or commodity trading advisor may present to the Commission proposals regarding any alternative method of addressing the effect of additions and withdrawals on the rate of return computation, including documentation supporting the rationale for use of that alternative method." Therefore, of the CFTC's Regulations, a CTA may use another method of addressing the effect of additions and withdrawals on the ROR calculation if the CTA ~~can demonstrate~~ submits a proposal to the CFTC, prior to use, that demonstrates that the alternate method provides an accurate picture of the CTA's ROR and is more appropriate for that CTA.

### **Exception to Compounded Returns**

CFTC Regulation 4.35 requires that the annual ROR, the peak-to-valley draw-down percentage and the net lifetime ROR be computed on a compounded monthly basis. However, for programs where net performance does not affect the nominal account size, and therefore profits are not reinvested, the CTA must sum the monthly performance returns instead of compounding them when calculating the annual return, the peak-to-valley draw-down percentage and the net lifetime ROR.

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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.

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<sup>1</sup> Another term often referred to in discussing partial funding is notional funds. Notional funds represent the difference between nominal account size and actual funds in a client's account.

<sup>2</sup> If cash additions, cash withdrawals and net performance will not affect the nominal account size, the CTA must provide in the written confirmation an affirmative statement to this effect.

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

<sup>23</sup> 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.

<sup>34</sup> Accounts in the same trading program generally have the same pattern of trading.

~~<sup>4</sup> Accounts that use different trading strategies should not be included in the same performance capsule even if their RORs are materially the same.~~

<sup>5</sup> 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" (paragraph 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.

~~<sup>6</sup> 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.~~

~~<sup>7</sup> A CTA is also not required to adjust its ROR calculation if additions and withdrawals are each less than 10% of the beginning net nominal account value for the period.~~

<sup>86</sup> The accounts can only be excluded when calculating ROR. They must be included in the CTA's capsule performance for other purposes, including reporting of total assets under management.

<sup>97</sup> An account that was open for the entire reporting period and had open positions or trading activity during the reporting period cannot be excluded even if it has not yet caught up to the performance of the other accounts in the program (unless its net additions and withdrawals exceeded 10% of its beginning net nominal account value for the period). An account with a trading pause cannot be excluded solely because of the trading pause, especially if the program dictated the trading pause. If the trading pause results from client-imposed restrictions that cause the account to be idle or traded differently from the other accounts in the trading program, ~~however~~, the account may belong in a different performance capsule.

<sup>408</sup> These instances should be rare. If the CTA's principal method frequently produces results that are materially different from the actual experience of accounts in the trading program, the CTA should change to a more consistent method.

<sup>449</sup> This information should be included in a footnote to the performance capsule. If the trading program experienced an unusual change in the number or size of additions, withdrawals, accounts opened, or accounts closed during the reporting period, the CTA should also highlight that change in a footnote and should describe the reason for the change, if known.

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## EXPLANATION OF PROPOSED AMENDMENTS

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As described more fully below, NFA's Board has approved amendments to an NFA Compliance Rule and two Interpretive Notices related to CPO and CTA disclosure and performance reporting. Specifically, the Board amended NFA's Interpretive Notice entitled *Compliance Rule 2-13: Break-Even Analysis* to clarify guidance to Member CPOs related to the preparation and presentation of the break-even analysis required by NFA Compliance Rule 2-13. Additionally, the Board amended NFA Compliance Rule 2-34 and the related Interpretive Notice entitled *Compliance Rule 2-34: Performance Reporting and Disclosures* to also provide guidance for Member CTAs related to performance reporting and disclosure requirements.

### Interpretive Notice entitled *Compliance Rule 2-13: Break-Even Analysis*

To clarify that CPOs may not use interest that cannot be reasonably anticipated (e.g., returns on high-risk bonds) to offset expenses, NFA's Board amended the Interpretive Notice entitled *Compliance Rule 2-13: Break-Even Analysis* to clarify that only interest expected to be earned by a pool's buy-and-hold cash management strategy from investments in high credit quality, short-duration instruments or deposits (e.g., T-Bills, cash on deposit at a bank or in a money market account, funds on deposit with a brokerage firm, interest in a money market mutual fund) may be used to offset expenses in the break-even analysis.

Additionally, NFA's Board also amended the Interpretive Notice to clarify that the break-even analysis must be based on both the minimum initial investment amount for a participant and the minimum total subscription amount required for a pool to commence trading to provide the participant with the most conservative break-even point. The Board also approved several other clarifying and technical amendments to the Interpretive Notice, including amendments that clarify when a redemption fee must be reflected in the break-even analysis or the explanatory notes and that provide additional guidance on handling incentive fees in the break-even analysis.

Compliance Rule 2-34 and the Interpretive Notice entitled *Compliance Rule 2-34: CTA Performance Reporting and Disclosures*

NFA Compliance Rule 2-34 and the related Interpretive Notice entitled *NFA Compliance Rule 2-34: Performance Reporting and Disclosures* set forth CTA performance reporting and disclosure requirements, including requirements for partially-funded accounts. Specifically, NFA Compliance Rule 2-34(b) requires CTAs with clients who have partially-funded accounts to either receive from or provide to a client a written confirmation that contains a description of the trading program and the nominal size of the client's account (*i.e.*, the account size agreed upon by the client that establishes the level of trading in a particular trading program). The Board believes that this confirmation requirement should also apply to accounts in which the client maintains an amount that exceeds the amount the client has directed the CTA to use as a basis for trading decisions, and therefore approved amendments to NFA Compliance Rule 2-34 and the Interpretive Notice to expand the confirmation requirement to these types of accounts

Further, the Board amended NFA Compliance Rule 2-34 to require that the required written confirmation required to be provided or received from all clients, including qualified eligible participants ("QEPs"), include an explanation of how cash additions, cash withdrawals and net performance will affect the nominal account size. Currently, the Rule does not require this information in written confirmations for QEPs. The Board believes the treatment of these items is an essential component in determining the nominal account size, and therefore, the Board amended NFA Compliance Rule 2-34 to specifically require that this information be provided to or received from all clients in a written confirmation regardless of their QEP status. The Board also amended NFA Compliance Rule 2-34 to further require that CTAs document any changes in a written confirmation if any of this information changes.

The Board also approved several other amendments to the Interpretive Notice entitled *Compliance Rule 2-34: Performance Reporting and Disclosures* to clarify and provide guidance related to existing requirements. Among other things, these amendments clarify that monthly performance returns must be summed instead of compounded when calculating rates of return and peak-to-valley draw-down percentages for programs in which net performance does not affect nominal account size.

NFA staff presented these proposed amendments to NFA's CPO/CTA Advisory Committee at its June meeting. The Advisory Committee supported the proposed amendments. As stated earlier, NFA's Board unanimously approved the proposed amendments on August 15, 2019.

As mentioned earlier, NFA is invoking the "ten-day" provision of Section 17(j) of the CEA. NFA intends to issue a Notice to Members establishing an effective date for the proposed amendments to NFA Interpretive Notice – *Compliance Rule 2 - 13: Break-Even Analysis*, NFA Compliance Rule 2-34 and NFA Interpretive Notice –



Mr. Christopher J. Kirkpatrick

August 29, 2019

*Compliance Rule 2-34: CTA Performance Reporting and Disclosures*, as early as ten days after receipt of this submission by the Commission, unless NFA is notified that the Commission has determined to review the proposal for approval.

Respectfully submitted,

A handwritten signature in black ink that reads "Carol A. Wooding". The signature is written in a cursive, flowing style.

Carol A. Wooding  
Vice President and General Counsel