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

[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.

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(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.**

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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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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.

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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.
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DJR:ckm(sub\021695)

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

April 26, 1995

RECEIVED
MAY 1 - 1995
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 2-13(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

nfa NOTICE TO MEMBERS

NATIONAL FUTURES ASSOCIATION
NOTICE I-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.

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:

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

May 30, 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 Section 11 of NFA's Code of Arbitration and Sections 2 and 11 of NFA's Member Arbitration Rules; and Resubmission of Proposed Amendments to the Interpretive Notice to NFA Compliance Rule 2-9 Concerning Supervision of Telemarketing Activity

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 Section 11 of NFA's Code of Arbitration and Sections 2 and 11 of NFA's Member Arbitration Rules. NFA also hereby resubmits proposed amendments to the Interpretive Notice to NFA Compliance Rule 2-9 Concerning Supervision of Telemarketing Activity which were submitted to the Commission for its review and approval by letter dated March 15, 1995. The amendments contained herein were approved by NFA's Board of Directors on May 18, 1995. NFA respectfully requests Commission review and approval of the proposed amendments.

<u>PROPOSED AMENDMENTS</u>

A. The proposed amendments to Section 11 of NFA's Code of Arbitration and Sections 2 and 11 of NFA's Member Arbitration Rules are as follows (additions are underscored and deletions are bracketed):

CODE OF ARBITRATION

* * *

Section 11. Arbitration Fees.

(a) Filing and Hearing Fees.

Except as provided in Section 18 of this Code, each party filing a claim under this Code shall pay a filing and hearing fee based on the amount claimed, including punitive and treble damages but exclusive of interest and costs, as follows:

Amount of Claim	Filing Fee	Hearing Fee	
$ 0.00 - $ 2,500.00	$ 50.00	$ 50.00	
$ 2,500.01 - $ 5,000.00	$ 100.00	$ 50.00	
$ 5,000.01 - $ 10,000.00	$ 150.00	$ 150.00	
$10,000.01 - $ 15,000.00	$ 175.00	[$ 450.00]	$ 500.00
$15,000.01 - $150,000.00	$ 200.00 plus 1% of excess over $15,000.00	[$ 675.00]	$ 725.00
More than $150,000.00	$1,550.00	[$1,350.00]	$1,450.00

Where multiple hearing sessions, including preliminary hearing sessions, are required in excess of those covered by the hearing fee, the arbitrators shall assess fees for the additional hearing sessions in an amount equal to the standard preset fees to be paid by the Secretary to the arbitrators for the additional hearing sessions. The arbitrators, in their discretion, may assess the entire fee against any party or may divide the fee among any or all parties. Hearing session fees shall be paid to the Secretary in advance of the hearing sessions to which they apply.

* * *

MEMBER ARBITRATION RULES

* * *

Section 2. Arbitrable Disputes.

(a) Claims. Except as provided in Sections 4 and 5 of these Rules with respect to timeliness requirements, disputes between and among Members and Associates shall be arbitrated under these Rules, at the election of the person filing the claim, [upon the filing of a claim by a Member or Associate] unless:

(1) the parties, by valid and binding agreement, have committed themselves to the resolution of such dispute in a forum other than NFA;

(2) the parties to such dispute are all required by the rules of another self-regulatory organization to submit the controversy to the settlement procedures of that self-regulatory organization; or

(3) all parties to the dispute are members of a contract market which has jurisdiction over the dispute.

<u>Once a claim is filed under the Rules, arbitration is mandatory for the Member or Associate the claim is against.</u>

* * *

Section 11. Arbitration Fees.

(a) Filing and Hearing Fees.

Each Member or Associate filing a claim under these Rules shall pay a filing and hearing fee based on the amount claimed, including punitive and treble damages but exclusive of interest and costs, as follows:

Amount of Claim	Filing Fee	Hearing Fee
$ 0.00 - $ 10,000.00	$ 750.00	$ 50.00
$10,000.01 - $ 20,000.00	$1,900.00	$ 150.00
$20,000.01 - $150,000.00	$4,400.00	[$ 675.00] <u>$ 725.00</u>
More than $150,000.00	$4,400.00	[$1,350.00] <u>$1,450.00</u>

Where multiple hearing sessions, including preliminary hearing sessions, are required in excess of those covered by the hearing fee, the arbitrators shall assess fees for the additional hearing sessions in an amount equal to the standard preset fees to be paid by the Secretary to the arbitrators for the additional hearing sessions. The arbitrators, in their discretion, may assess the entire fee against any party or may divide the fee among any or all parties. Hearing session fees shall be paid to the Secretary in advance of the hearing sessions to which they apply.

B. The proposed amendments to the Interpretive Notice to NFA Compliance Rule 2-9 Concerning Telemarketing Activity are as follows (additions are underscored and deletions are bracketed). The following text replaces the proposed text submitted on March 15, 1995:

INTERPRETIVE NOTICE TO COMPLIANCE RULE 2-9:
<u>SUPERVISION OF TELEMARKETING ACTIVITY</u>

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

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

For purposes of this requirement, a [d]<u>D</u>isciplined [Member] [f]<u>F</u>irm 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 <u>currently</u> meeting the definition of a [d]<u>D</u>isciplined [f]<u>F</u>irm. 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] <u>telephone conversations</u> which occur <u>between their APs and both existing and potential customers</u>[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] <u>these conversations</u> provides these Members with the best opportunity to monitor closely the [sales solicitations] <u>activities</u> 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] <u>these conversations</u> for a period of one year and must retain such tapes for a period of [six months] <u>one year</u>.

<u>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.</u>

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.

EXPLANATION OF PROPOSED AMENDMENTS

A. Explanation to Proposed Amendments to NFA's Code of Arbitration and Member Arbitration Rules

- **Additional Honorarium for Chairman of an Arbitration Panel**

At the time NFA's arbitrator payment schedule was adopted, the extra duties performed by a panel chairman were minimal. However, that is no longer the case. NFA arbitration cases have increased in complexity and the average claim amount has increased from $63,091.00 in 1991 to $191,959.49 in 1994. As a result, the number of pre-hearing motions being filed in NFA cases has increased. Since the chairman is responsible for calling the other members of the panel and ensuring that pre-hearing motions are ruled on, the chairman's role has increased substantially. In light of this, NFA's Board of Directors determined that the chairman of a three-person panel should receive an additional honorarium of $50. In other words, the chairman will receive $200 for a half-day oral hearing and $275 for a full-day oral hearing.

The entire cost of paying the arbitrators is passed through to the parties by initially assessing a hearing fee to the party filing the claim. Consequently, NFA proposes an amendment to Section 11 of NFA's Code of Arbitration and Member Arbitration Rules to adjust the hearing fees charged by NFA for claims where a chairman is appointed (i.e., claims over $10,000 in customer cases and claims over $20,000 in Member cases). Since most of NFA's claims are filed by customers, customers would initially be subjected to the increased cost for arbitration. However, arbitrators can, and often do, order Members to reimburse customers for the hearing fees. In any event, the proposed increases are slight and NFA arbitration is still a relatively low cost alternative for resolving disputes.

- **"Mandatory Claims" Under the Member Arbitration Rules**

Rules making the arbitration of Member disputes mandatory for the respondent have been effective since March 1992. Under the Member Arbitration Rules, NFA arbitration is mandatory for the respondent but not the claimant. In other words, the choice of whether to file a claim under the

Rules is up to the Member or Associate who suffered the loss (subject to certain restrictions set forth in Section 2 of the Rules and the terms of a contractual provision requiring the parties to arbitrate at NFA). As long as NFA has jurisdiction under Section 2, however, once a claim is filed at NFA the Member or Associate the claim is against is required to submit.

Before the Rules were adopted, NFA staff conducted a survey of the membership and asked, among other things, about the type of arbitration format Members and Associates would prefer. Of those Members and Associates who were in favor of mandatory Member-to-Member arbitration, 65 percent preferred an arrangement which would allow the Member or Associate with the claim, at his option, to file for arbitration at NFA and would then compel the other party to arbitrate here. This is the approach that NFA's Advisory Committees, Executive Committee and Board adopted.

NFA staff believes, however, that the intent of the Rules may not be clear to someone reading the Rules without knowledge of their history. Specifically, there have been several instances where the Member with the claim has chosen to file in court and the Member respondent argued that the Rules require the claim to be arbitrated at NFA. NFA is aware of at least one case that was ordered to NFA arbitration after this argument was made, though it is not clear whether the language in the Rules was the basis for the judge's decision in that case. As a result, the Member who actually suffered the loss may have been denied the opportunity to proceed in the forum of its choice.

The proposed amendment to Section 2 of the Member Arbitration Rules makes it crystal clear that the Member who has the claim can select the forum of its choice (unless there is a contract to the contrary).

B. Explanation of Proposed Amendments to the Interpretive Notice to NFA Compliance Rule 2-9 Concerning Supervision of Telemarketing Activity (the following explanation replaces the explanation submitted on March 15, 1995)

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.

Finally, although the Telemarketing Requirements have been very useful to NFA staff for gathering evidence in enforcement actions relating to deceptive telemarketing sales activities, an NFA Member firm subject to the Telemarketing Requirements is only required to retain tape recorded conversations for a period of six months. NFA staff has found that this short retention period has hampered NFA's ability to fully investigate a Member's compliance with the Telemarketing Requirements. Therefore, NFA is proposing that the Interpretive Notice be amended to require Members meeting the Telemarketing Requirements' criteria to retain tapes for a period of one year.

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.
Alan L. Seifert, Esq.
Susan C. Ervin, Esq.
Lawrence B. Patent, Esq.
David Van Wagner, Esq.

DJR:ckm(sub\051895)

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 pro forma 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 <u>pro forma</u> 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 <u>pro forma</u> 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 <u>pro forma</u> results to adjust for differences in commissions and fees as long as the <u>pro forma</u> results are not calculated in a misleading manner. Members and Associates may not, however, use <u>pro forma</u> results which reflect a hindsight analysis. For example, CPOs may not use <u>pro forma</u> 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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U.S. COMMODITY FUTURES TRADING COMMISSION

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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

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

December 22, 1995

Andrea M. Corcoran
Director
Division of Trading & Markets
Commodity Futures Trading
Commission
Three Lafayette Centre
1155 21st Street, N.W.
Washington, D.C. 20581

Dear Andrea:

Much of our discussion over the last two years concerning the notional funds issue and proposed NFA Compliance Rule 2-34 has centered on the so called "discipline in the denominator" issue. In general, we have used this phrase as a short hand description for the overall concern that a CTA should not be able to use notional funding of accounts to distort the presentation of his past performance. More specifically, the Commission staff has noted that in soliciting institutional clients a CTA may have an incentive to flatten its performance, showing lower rates of return, smaller drawdowns and less dramatic swings in its overall performance.[1] One way a CTA could accomplish this would be by using notional funding to artificially inflate the BNAV in its performance calculations. By inflating that number, while at the same time reducing the percentage of customer assets generally devoted to margin, the CTA would be making the same trades for the same customers but would reflect much flatter performance in its capsule history.

Commission staff has also voiced a related, though distinct, concern that given the widely varying degrees of leverage CTAs use in their trading, a customer may not be provided with sufficient information to make an informed comparison between any two CTAs. Though both may show identical rates of return in their disclosure documents, one may have achieved that return by using much more leverage than the other and, thus, exposing his clients to a greater risk of wide swings in his

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[1] The Commission has also expressed concerns over the potential abuses stemming from the solicitation of less sophisticated "retail" accounts for participation in a partially funded managed account. NFA has addressed these concerns through the adoption of a separate Interpretive Notice which is also pending Commission review.

periodic performance. This issue, of course, is not limited to notional funding situations. No two CTAs trade in identical ways and the comparison problems described above will always be present regardless of how BNAV and rates of return are calculated.

Commission staff has requested further explanation of how NFA's proposed rule would address each of these concerns. NFA, of course, shares the Commission's goal of ensuring that CTA performance histories are not susceptible to distortion and that customers receive the information they need to make informed investment decisions. As explained below, NFA believes that its current proposal addresses each of the concerns outlined above and strengthens the overall level of customer protection.

One way in which NFA's proposal improves the overall level of "discipline in the denominator" stems from the rule's requirement that CTAs maintain written and signed agreements for **all** customers, specifying, among other things, the amount the CTA is to use as the basis for its trading decisions. This requirement provides assurances that the BNAV for any notionally funded account cannot be set unilaterally by the CTA but only with the signed consent of the customer. Moreover, this requirement provides much tighter documentation regarding notionally funded accounts than Interpretive Letter 93-13.

We understand that the Commission staff interprets that letter to require signed documentation from any customer whose account is notionally funded. However, requiring such documentation only for notionally funded accounts opens the door for unscrupulous CTAs to distort their performance. Such CTAs could decide, with the benefit of hindsight, to calculate performance based on actual funds rather than the notional funding level agreed to by the customer by simply discarding the written agreements. Without a requirement for documentation for all customers, the absence of such an agreement would not be notable during an audit.

The enhanced disclosures called for under the rule also improve the "discipline in the denominator" by ensuring that any customer who agrees in writing to participate in a partially funded account would receive adequate information to make a fully informed decision on that issue. Thus, the rule requires CTAs to disclose the percentage of customer assets generally committed to margin for a fully funded account and how that percentage would be affected by the practice of partially funding an account. For example, if a CTA anticipates that he would generally devote no more than 30% of the assets of a fully funded account to margin, he would have to explain to a customer who wishes to deposit only half of his nominal account size with the FCM that up to 60% of the customer's deposit could be devoted to margin. Committing this higher percentage of customer assets to margin obviously increases the potential for margin calls to the customer from the FCM. To make this point expressly clear, the rule provides that CTAs must provide any customer not fully funding its account with a clear description of how partial funding will increase the frequency and size of margin calls. The CTA would also have to fully describe how partial funding would affect the computation of management fees. Specifically, the CTA must express its management fees as a percentage of the nominal account size and provide a complete description of how that percentage could be affected by partially funding the account. In addition, the CTA must provide an estimate of the commissions which would be charged to a fully funded account on an annual basis. That estimate must be expressed as a percentage of the nominal account size. The CTA must further explain how that percentage would be affected by partially funding an account.

The requirement that CTAs disclose their margin to equity ratios also addresses the Commission's concern that current disclosure requirements may not provide customers with sufficient information to make informed comparisons between CTAs. With this additional information customers can see not only what returns a CTA achieved but how much leverage he used to achieve those results, thus allowing the customer to make a more informed investment decision.

The rule further strengthens the "discipline in the denominator" by ensuring that the minimum account size set by the CTA for any particular trading program will be the result of a rationale analysis of relevant factors, rather than an arbitrary number set by the CTA solely to enhance the presentation of its performance history. Based on our discussions with Commission staff, we amended the proposal to require that CTAs disclose in writing the factors considered by the CTA in setting the minimum account size for the relevant trading program. Obviously, each CTA has its own, unique approach to trading, and, given each CTA's individual trading style, the appropriate minimum account size cannot be determined by any uniform, industry wide mathematical formula. While that level of precision is unattainable, we would, nevertheless, expect each CTA to comply with the rule by explaining the various factors taken into account in setting the minimum account size for the relevant trading program. We would expect these factors could include items such as the degree of diversification the CTA seeks to achieve, the range of markets the program may be trading in, the historical volatility of those markets, the anticipated frequency of trading in the program and the overall financial condition of customers for whom the trading program might be appropriate. Based on these types of factors, we would expect CTAs to explain in writing how the established minimum account size would affect a customer's ability to participate in all of the trading signals generated by the program and the likelihood and frequency of calls for additional margin.

In sum, NFA's rule addresses the specific regulatory concern that CTAs may attempt to make their performance more attractive to institutional customers by flattening their overall performance. The only way a CTA could accomplish this would be to inflate its BNAV by inducing its institutional customers to agree to an artificially high nominal account size. By ensuring that these institutional customers are provided with clear information on all of the potential ramifications of partial funding, we believe that the proposed rule provides customers with important information, reduces the possibility that a CTA could distort its performance history and strengthens the overall level of customer protection.

Very truly yours,

Daniel J. Roth
General Counsel

/pjf(Ltrs/Corcoran.DJR)

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DIVISION OF
TRADING & MARKETS

RECEIVED
JAN 2 - 1996
COUNSEL'S OFFICE

December 26, 1995

Daniel J. Roth, Esq.
Vice President and General Counsel
National Futures Association
200 West Madison Street
Chicago, ILLINOIS

Dear Dan:

Thank you for your letter of December 22, 1995 regarding the continuing question of how best to address determining the denominator for purposes of reporting commodity trading advisor performance as required by Commission regulations. As you know, we are currently waiting further empirical information from you on how some CTAs who use "notional accounts" determine the account sizes for those accounts.

As you note in your letter, the NFA proposal relative to "notional accounts" would require any CTA offering such accounts to provide an explanation of the factors that such CTA uses to determine account size. We were hopeful, based on our previous conversations, that you would be able to provide us with some fairly specific descriptions about how several CTAs would currently describe how they set such sizes. In other words, we are interested in seeing a better explanation of what NFA's expectations would be with respect to the detail by which such factors would be set forth and described in response to NFA's proposal. We are also interested in what types of explanations you have obtained or documented based on your audit experience and/or the inquiries that you had committed to make to date.

Frankly, I believe that, while helpful, your letter of the 22d of December is not really responsive as to the account size issue. We were already aware that, like margin, such sizes might reflect volatility and leverage--the idea was to get some more input as to how. We were hoping for a greater level of specificity--with examples-- particularly so that we might be better able to evaluate how effective NFA's proposal would likely be as a potential discipline on the denominator used for performance reporting. Indeed, the failure to date by the industry to provide some indication as to how such account sizes are set has caused the academic community and other regulators to question the legitimacy of using a "notional account" size--especially where there is no fully funded subset of accounts. To the extent notional amounts are referred to in over-the-counter and other transactions, such amounts measure the full size ("principal amount") on which the contract is written.

In order for the Commission to find a workable solution (other than the one developed to date) the requested information is essential. We would like to be able to approach this issue very positively, as well as logically, and hence we await an early response from you on this matter.

Very truly yours,

Andrea M. Corcoran
Director

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.

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COMMODITY FUTURES TRADING COMMISSION 1975

August 14, 1996

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

Re: The National Futures Association's Proposed Amendments to Interpretive Notice to Compliance Rule 2-9 -- Telemarketing Supervision Requirements

Dear Mr. Roth:

By letters dated March 15, 1995, and May 30, 1995, the National Futures Association ("NFA") submitted to the Commission for its approval, pursuant to Section 17(j) of the Commodity Exchange Act ("Act"), proposed amendments to the Interpretive Notice to Compliance Rule 2-9 concerning telemarketing supervision requirements.

Please be advised that on this date the Commission has determined to approve, pursuant to Section 17(j) of the Act, the proposed amendments to the Interpretive Notice to Compliance Rule 2-9.

The Commission understands that NFA will continue to consider additional modifications to its Interpretive Notice to Compliance Rule 2-9. The Commission reminds NFA of the Division of Trading and Markets' ("Division") earlier request that NFA continue to vigorously monitor telemarketing practices in the industry as part of its program to review sales practices and that NFA apprise the Division if it finds problems related to telemarketing in the course of these reviews. At the same time, the Division further requested that NFA submit a report to the Commission by January 31, 1997, concerning any deceptive or abusive sales practices discovered during the course of any reviews conducted in 1996. <u>See</u> January 18, 1996, letter to Robert K. Wilmouth, NFA President and Chief Executive Officer, from Andrea M. Corcoran, Division Director.

Sincerely,

Catherine D. Dixon

Catherine D. Dixon
Assistant to the Secretary of the Commission

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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. Proposed Deletion of NFA Compliance Rule 2-8(e)(2) (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.

NFA

Ms. Jean A. Webb February 26, 1998

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
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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. Disclosure of Risk Profile Data on Partially-Funded CTA Programs

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. Presentation of Risk Profile Data on Commodity Pools

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, NFA

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)

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 <u>underscored</u> and deletions are ~~stricken through~~)

COMPLIANCE RULES

* * *

PART 1 – DEFINITIONS

RULE 1-1. DEFINITIONS.

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

(b) <u>**"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.</u>

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

~~(c)~~<u>(d)</u> **"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)~~<u>(e)</u> **"Business Conduct Committee"** – means the Business Conduct Committee established under NFA Bylaw 704.

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

~~(f)~~<u>(g)</u> **"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

* * *

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

[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.

* * * * *

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.

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,

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Vice President and General Counsel

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

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