

September 1, 1994

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

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

Dear Ms. Webb:

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

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

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

**PROPOSED AMENDMENTS TO NFA COMPLIANCE RULE 2-29**

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

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<sup>1</sup> 59 Fed. Reg. 30776 (1994).



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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



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in a manner consistent with that required under CFTC Rule 4.21(a)(4)(ii)(F).

(c) Hypothetical Results.

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

HYPOTHETICAL PERFORMANCE RESULTS HAVE MANY INHERENT LIMITATIONS, SOME OF WHICH ARE DESCRIBED BELOW. AS A RESULT OF THESE LIMITATIONS, HYPOTHETICAL PERFORMANCE RESULTS HAVE LIMITED PREDICTIVE VALUE. IN FACT, THERE ARE FREQUENTLY SHARP DIFFERENCES BETWEEN HYPOTHETICAL PERFORMANCE RESULTS AND THE ACTUAL RESULTS SUBSEQUENTLY ACHIEVED BY ANY PARTICULAR TRADING PROGRAM.

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

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



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(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.



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[(e)](f) Recordkeeping.

\* \* \*

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

\* \* \*

[(g)](h) Definition.

\* \* \*

PROPOSED INTERPRETIVE NOTICE TO NFA COMPLIANCE RULE 2-29

**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.



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

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

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



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trading program, newsletter or market letter, shall, at a minimum, adhere to the following requirements.

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

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

Third, when any Member or Associate utilizes promotional material which contains both hypothetical and actual performance results, then the actual results must be presented with at least the same prominence devoted to the hypothetical results. Both the hypothetical and actual performance results must be appropriately identified, separately formatted, discussed



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in an equally balanced manner and calculated pursuant to the same rate of return method. Furthermore, the promotional material must not contain any statement which places undue emphasis on the hypothetical performance results, for example, by discounting or downplaying the significance of any actual performance results.

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

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

#### **EXPLANATION OF PROPOSED AMENDMENTS AND INTERPRETIVE NOTICE**

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



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

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

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

Due to these remaining problems, the Discussion Group developed a more expansive proposal which imposes further limitations relating to the use of hypothetical performance results in promotional material. This proposal includes additional amendments to Compliance Rule 2-29(c) which adopt an expanded disclaimer and the issuance of an Interpretive Notice Relating to the Use of Promotional Material Containing Hypothetical Perform-



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ance Results ("Interpretive Notice"). In drafting the expanded disclaimer, the Discussion Group felt that a more thorough discussion of the limitations of hypothetical results and of the dangers of placing reliance upon such results is necessary to adequately protect customers from abuses associated with the use of those results.

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

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

In view of the additional protections and restrictions contained in its proposal, the Discussion Group felt that the



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

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

Sincerely,



Daniel J. Roth  
General Counsel

DJR:ckm(sub\081894.hyp)

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

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.



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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



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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.



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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.



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- (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.**

\* \* \*



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- 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.
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**NFA COMPLIANCE RULE 2-29**

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

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

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



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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



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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



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performance results, for example, by discounting or down-playing the significance of any actual performance results.

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

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

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

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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 interpre-



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tive 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



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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,

A handwritten signature in black ink, appearing to read 'Daniel J. Roth', written in a cursive style.

Daniel J. Roth  
General Counsel

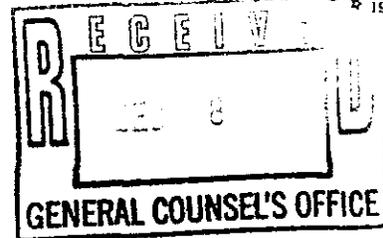
cc: Chairman Mary L. Schapiro  
Commissioner Barbara Pedersen Holum  
Commissioner Joseph P. Dial  
Commissioner John E. Tull, Jr.  
Andrea M. Corcoran, Esq.  
Geoffrey Aronow, Esq.  
Alan L. Seifert, Esq.  
Susan C. Ervin, Esq.  
Lawrence B. Patent, Esq.  
David Van Wagner, Esq.

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

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



December 12, 1995



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).

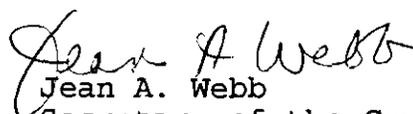
Mr. Daniel J. Roth

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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,

A handwritten signature in cursive script that reads "Jean A. Webb".

Jean A. Webb  
Secretary of the Commission

December 27, 1995

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

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

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

May 28, 1996

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

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

Dear Ms. Webb:

Pursuant to Section 17(j) of the Commodity Exchange Act, as amended, National Futures Association ("NFA") hereby submits to the Commodity Futures Trading Commission ("Commission" or "CFTC") proposed deletion of NFA Compliance Rule 2-19 and proposed amendments to NFA Compliance Rules 2-8(b) and 2-29(c) and the Interpretive Notice Relating to the Use of Promotional Material Containing Hypothetical Performance Results. The proposals contained herein were approved by NFA's Board of Directors on May 16, 1996. NFA respectfully requests Commission review and approval of the proposals.

**PROPOSED AMENDMENTS**

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

**COMPLIANCE RULES**

\* \* \*

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

\* \* \*



Ms. Jean A. Webb

May 28, 1996

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

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

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

**COMPLIANCE RULES**

\* \* \*

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

\* \* \*

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

\* \* \*

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

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



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

\* \* \*

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

COMPLIANCE RULES

\* \* \*

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

\* \* \*

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

\* \* \*

(c) Hypothetical Results

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



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

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

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

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

- (2) Any Member or Associate who uses promotional material which includes a measurement or description of or makes any reference to a hypothetical composite performance record showing what a multi-advisor account portfolio or pool could have achieved in the past if assets had been allocated among particular trading advisors must



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

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

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

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

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



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

- [2] (3) Any Member or Associate who uses promotional material which includes a measurement or description of or makes any reference to hypothetical performance results which could have been achieved had a particular trading system of the Member or Associate been employed in the past must include in the promotional material comparable information regarding:
- (i) past performance results of all customer accounts directed by the Member pursuant to a power of attorney over at least the last five years or over the entire performance history if less than five years;
  - (ii) if the Member has less than one year experience in directing customer accounts, past performance results of his proprietary trading over at least the last five years or over the entire performance history if less than five years.
- [3] (4) Any Member or Associate utilizing promotional material containing hypothetical performance results must adhere to all the requirements contained in the Board's Interpretive Notice relating to this issue. [See Interpretive Notice at ¶ 9025.]
- [4] (5) These restrictions on the use of hypothetical trading results shall not apply to promotional material directed exclusively to persons who meet the standards of a "Qualified Eligible Participant" under CFTC Regulation 4.7.

# # # #



Ms. Jean A. Webb

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**NFA COMPLIANCE RULE 2-29**

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

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

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

In NFA's experience, however, the use of the mandated disclaimer has not prevented recurring abuses in the presentation of hypothetical results. In some instances Members have touted dramatic hypothetical profits without revealing that their actual performance is much worse. This situation has been addressed by an amendment to NFA Compliance Rule 2-29(c)(2) which requires Members advertising hypothetical results to disclose their actual



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results as well. In other cases Members have effectively diminished the impact of the disclaimer by grossly over-emphasizing the significance of very dramatic hypothetical profits. For example, some Members have utilized promotional material which present hypothetical rates of return in large, bold face print while the disclaimer can be read only with a magnifying glass. In other advertising pieces the disclaimer is so far removed from the touted hypothetical profits that customers may never find it. There have also been instances in which Members or Associates have attempted to disguise hypothetical performance results as actual performance results.

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

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



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precede or follow the performance results. Whenever the Member or Associate has less than twelve months of actual results, the disclaimer must immediately precede the hypothetical performance results. Furthermore, if the promotional material contains several pages of hypothetical performance results, then the Member or Associate may need to include this disclaimer more than once in the material.

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

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

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



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

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

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

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



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

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



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**EXPLANATION OF PROPOSALS**

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

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

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

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

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

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

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



Ms. Jean A. Webb

May 28, 1996

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

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

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

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

NFA

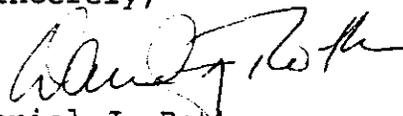
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Ms. Jean A. Webb

May 28, 1996

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

DJR:ckm(sub\051696)

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

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



August 29, 1996

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

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

Dear Mr. Roth:

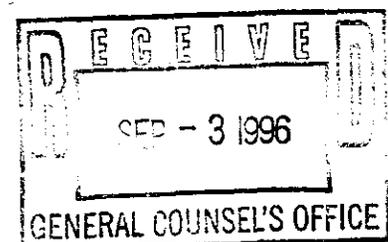
By letter dated May 28, 1996, and received May 31, 1996, the National Futures Association submitted to the Commission for its approval, pursuant to Section 17(j) of the Commodity Exchange Act ("Act"), the above-referenced proposed rule amendments and rule deletion.

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

Sincerely,

A handwritten signature in cursive script that reads 'Jean A. Webb'.

Jean A. Webb  
Secretary of the Commission



February 7, 1997

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

Dear Andrea:

When the Commission approved NFA rule changes placing further restrictions on the use of hypothetical trading results, along with an accompanying Interpretive Notice, the Commission requested that after one year NFA report to the Commission on whether the rule changes adopted had effectively dealt with the misleading use of hypothetical trading results. As you will recall, the rule changes adopted by NFA were intended to prohibit certain misleading advertising practices which NFA had encountered on a recurring basis over the years. Specifically, NFA had seen instances in which firms:

- touted glowing hypothetical trading results for trading programs which had, in fact, generated actual trading results sharply different than the hypothetical ones;
- highlighted the hypothetical trading results for a new program without disclosing that actual results for other programs previously developed by the firm were sharply different;
- buried required disclaimers in sections of the promotional material far removed from the hypothetical results; or
- presented hypothetical results in a manner designed to induce customers to place undue reliance on those results.

Since the Commission approved the NFA rule changes in December 1995, we have continued to monitor the use of hypothetical trading results by Member firms in a number of ways. Our audit steps include careful review of promotional material which has been used by Member firms. In addition, many Member firms continue to submit their promotional material to NFA, either as part of NFA's voluntary pre-review program or because they have been ordered to do so pursuant to NFA Compliance Rule 2-29(f). Furthermore, NFA routinely monitors the advertising in numerous publications and periodicals



Ms. Andrea M. Corcoran

February 7, 1997

as well as promotional material disseminated through the Internet. Finally, all customer complaints or inquiries are carefully reviewed to detect possible rule violations.

We cannot report to the Commission that our surveillance indicates no further problems regarding the misleading use of hypothetical trading results. We can report, however, that in virtually every instance in which we have noted the types of problems described above, the advertising was produced by a non-Member firm, which, in many instances, was not even registered. Compliance with the new rules by NFA Member firms has been superb. While we still encounter serious sales practice problems within a limited number of firms, we have not had to refer a single disciplinary matter to a Business Conduct Committee involving the types of abuses described in the Interpretive Notice Relating to the Use of Promotional Material Containing Hypothetical Trading Results since it was approved by the Commission.

As we have discussed before, one step which might help police the use of misleading promotional material by non-members of NFA would be to amend CFTC Regulation 170.15. That rule currently provides that any firms required to be registered as FCMs must be a member of a registered futures association. In conjunction with NFA Bylaw 1101, this rule ensures that most futures professionals dealing with the public will be subject to NFA sales practice rules. CTAs who do not manage customer accounts, however, are not required to be members of NFA. Amending CFTC Regulation 170.15 to require firms required to be registered as FCMs, IBs, CPOs and CTAs to be members of a registered futures association could help ensure that registered CTAs who do not manage customer accounts would be held to the same sales practice standards as the rest of the industry.

If you would like to discuss any of the points covered in this letter, please do not hesitate to contact me.

Sincerely,

A handwritten signature in black ink, appearing to read 'D. Roth', written over a horizontal line.

Daniel J. Roth  
General Counsel

DJR:ckm(ltr-dr\hypoth)