

CFTC Letter No. 99-21

May 11, 1999

Interpretation

Division of Trading & Markets

Dear X:

This is in response to your letter of April 19, 1999, in which you request an interpretative letter regarding the performance presentation requirements of Part 4 of the Commission's regulations.

Based upon the representations made in your letter, and information obtained in a subsequent telephone conversation of May 4, 1999, the relevant facts appear to be as follows. XX, a Commodity Trading Advisor ("CTA") and a Commodity Pool Operator ("CPO") registered with the Commission, utilizes two trading programs to trade customer funds (Y and Z). All of XX's accounts are traded pursuant to one of these programs ("Trading Programs"). You indicate that there are significant differences in the net performance numbers across accounts attributable "to the terms, dictated by the client, on which an account's performance is calculated."

In your letter you present a detailed discussion which indicates that a large part of the disparity in the performance numbers is due to either the treatment of interest income, or the use of wrap fees by the clients. We will look at each item separately.

Treatment of Interest Income Your letter indicates that "for some of XX's accounts, the client has dictated that interest income, earned through money management, not be included as a component of total performance, but instead be considered an addition to capital." You request that you be allowed to add adjustments to performance tables to account for the interest income of these accounts. Based upon subsequent staff communications, it appears that in some cases the client/CPO retains control over a portion of the funds rather than depositing them directly into an account over which the CTA has trading authority. In these cases the client/CPO will use its own discretion to manage the excess cash and thereby earn interest thereon.

Underlying the requirement to present past performance in the disclosure documents of CTAs is the premise that the participant is entrusting the CTA with the management of the participant's money. To the extent gains and losses are attributable to the CTA's money management service, such gains and losses should be included in the performance presentation. To the extent gains and losses are NOT attributable to the CTA's money management service, such gains and losses should NOT be included in the performance

presentation.

Therefore, in those cases where XX is directly responsible for the money management strategy that results in the interest earned, that interest income MUST be included as a component of total performance. However, in those cases where XX is not responsible for the direct money management strategy, the interest income may not be imputed to be performance of XX.

The Division recognizes that certain clients may request that they be provided with performance presentations regarding their own accounts that are tailored to meet their needs, using calculations or a format different from that required by CFTC Rules. XX is free to provide information to clients as to the performance of their accounts using parameters the clients have defined. However, XX must follow CFTC regulations for the presentation of past performance in its disclosure document.

Wrap Fees In your letter you indicate that "some accounts. . . impose wrap fees instead of standard commissions. Wrap fees are charged as a percentage of total assets under management and include client imposed administrative and management fees in addition to trading commissions."

The use of wrap fees in the commodity industry is relatively new. The Commission is aware of the use of wrap fees which are, in most cases, used by a CPO who has a pool using several CTAs (or where the CPO is an affiliate of the FCM) and finds it to be cost effective to negotiate a fixed fee arrangement with the FCM(s) where the accounts are carried rather than to pay the round turn commissions generated separately by each individual CTA. In some cases the CPO will deduct their management and incentive fee at this point as well. Generally, the CPO will tell each CTA what its proportional amount of the wrap fee is, based upon assets under management, and not the actual round turns for which that CTA is responsible.

The principle underlying the decision as to what past performance should be included in the CTA's disclosure document is the same for wrap fees as for interest income. The portion of the wrap fee that is attributable to the CTA's share of the trading expense should be utilized when calculating the rate of return for the CTA.

Furthermore, if the CPO's management and incentive fees are included within the "wrap fee," they should not be charged against the CTA's trading results. These fees are disclosed in the pool's disclosure document and also should be part of the management agreement between the CTA and the CPO. Further, any other fees charged to the pool (*e.g.*, office expenses) that are not directly attributable to the trading of the pool's account by the CTA should be deducted from the wrap fee prior to the CTA calculating its performance.

XX's CPO clients may negotiate with their respective FCMs the terms for covering the trading costs for the pool in a manner which is most favorable to the pool as a whole, just as non-CPO clients may have negotiated a range of round turn commissions with the FCM that will be carrying their account. As a consequence, the portion of the wrap fee that is attributable to XX's proportion of the pool's trading is the appropriate expense that should be deducted in preparing XX's performance presentation for use in its disclosure document.

Further, you are reminded that Commission Rule 4.35(a)(3)(ii) states that:

"Accounts that differ materially with respect to the rates of return may not be presented in the same composite."

Therefore, should the rates of return for accounts using either the Y or the Z program differ materially from other accounts utilizing that same trading program after the application of the principles set forth in this letter then the performance should be broken out into separate tables that comply with Rule 4.35.

This letter, and the interpretation contained herein, is based upon the representations provided to us. Any different, changed or omitted material facts or circumstances might render this interpretation void. You must notify us immediately in the event that XX's operation of the Trading Programs change in any material way from that represented to us. Further, you should be aware that the Commission recently published for public comment a concept release regarding the presentation of past performance for CTAs and CPOs. The Commission may, as a result of comments received, propose and ultimately adopt a regulatory change. If a regulatory change is adopted, it may supercede the interpretation set forth herein.

If you have any questions concerning this letter, please contact Kevin P. Walek at (202) 418-5463.

Very truly yours,

Robert B. Wasserman

Associate Director