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COMMENT

Received CFTC Records Section
4/15/03

April 15, 2003

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

RE: "Account Identification for Eligible Bunched Orders"

Dear Ms. Webb:

I hereby submit my comments in response to the Commission's request for comment on the above-referenced rule proposal. I am a certified public accountant and hold an MBA (concentration in finance). As of March 31, 2002, I completed a career involving accounting, auditing, financial reporting and regulatory matters. The first 7 years of my career was with an international auditing firm. The balance of my career comprised 29 years in the Federal Government, including: 3 years at the Securities and Exchange Commission (Division of Corporation Finance); 7 years at the Department of Energy (Financial Reporting System Project); and, lastly, 19 years at the Commodity Futures Trading Commission ("CFTC" or "Commission"), serving for most of those years as a deputy director in the Division of Trading and Markets.

The standard to be met by a rule in the trade area is that it would make abuse of customers risky, because it requires books, records and controls, which form the basis for trade practice surveillance, audits and enforcement cases. In this regard, adoption of the rule, as proposed, would actually constitute a weakening of the Commission's existing rules, with a consequent enhancement of the opportunities for illicit trade transactions by

account managers. As explained below, under the proposed rule, it would no longer be necessary for the crooked account manager to take the market risk of trading ahead of his customer, in hopes of gaining a price advantage. Instead, he will have a "sure thing", because this proposed rule will permit him to wait until the end of the day to make the trade allocations, which is a time when he will know whether there is a profit to siphon off. Therefore, this proposed rule should be amended, to require internal control systems, procedures and regulatory audits sufficient to make fraudulent trade allocations difficult (by making collusion necessary to pull off a fraud) and to facilitate the gathering of evidence for enforcement actions. In this connection, discussed in detail below, are the following recommendations for the consideration of the Commission:

1. Require internal controls over accounts sufficient to preserve an audit trail.
2. Define allocation bias and require measurement of it with an appropriate accounting system. Specify what corrective action must be taken if it occurs.
3. Permit the use of average pricing systems as an alternative to accounting for and assessing the extent of allocation bias.
4. Require account managers to review their own allocations for bias and file reports with NFA.
5. Require NFA to provide adequate audit coverage of trade allocations.
6. As it is not useful as an indicator of bias, drop the requirement for a composite table.

Following is a detailed discussion of my recommendations.

1 - Require internal controls over accounts sufficient to preserve an audit trail.

The proposed rule lacks controls to prevent fraudulent manipulation of the allocation of the trades to the accounts of customers. The proposed rule will allow the account manager to submit account numbers to the FCM, after the end of the trading, with no restrictions. The dishonest account manager, however rare he may be, will be able add in or leave out proprietary or favored accounts, at will, depending upon how the market moved post execution of the bunched trades. Because of the lack of

restrictions in the rule, if an account manager were so inclined, customers may get trades they were not intended to get at the time of order submission -- or, they may get fewer contracts than they were originally intended to be allocated – all depending upon how the market had moved the remainder of the day, from the time the trades were executed. This ability to operate so freely, without constraint or any record of action, is a violation of basic audit trail concepts, as explained further below.

An important aspect of the audit trail is that every contract, executed on an exchange, can be traced back to its original placement with the FCM by the account manager. This linkage establishes proof positive that the accounts of customers contain no more and no less than the contracts to which they are entitled and were intended to get by the account manager. This linkage, along with time stamping at each stage of the processing of the orders, provides the mechanism to show whether the orders were handled for the benefit of the customers, or not, according to the Commission's rules.

Therefore, I recommend the Commission require that an account manager, in order to be eligible to submit bunched orders, be required by rule to have a system of identifying *in advance* the accounts for which bunched orders are to be placed. The system should include specification of the exact proportion of each bunched order (that is, the fractional share of any order placed, e.g., 10 percent) to be allocated to each of the accounts in the identified group. The group should have a unique "short-code" identifier. This information should be required to be provided to the FCM handling the orders *in advance* of the acceptance of any orders. This information would be used by the FCM to allocate the trades at the end of the trading day, to the customers' accounts designated in advance of the order and in proportions also designated in advance.

This recommendation is similar to a recommendation provided in the industry report entitled: "Recommendations for Best Practices in Order Entry and Transmission of Exchange-Traded Futures and Options Transactions" (referred to herein as the "Best Practices Report"), which is referred to in the release. The recommendation in the Best Practices Report states that, with respect to some types of accounts: " . . . intermediaries should develop procedures that satisfy customers' business imperatives, while assuring customer protections comparable to those afforded by recording the complete account identifier. A 'short-code' is an example of such a procedure." It was not indicated in the Best Practices Report why its

recommendation was limited to only certain accounts, such as institutional accounts. However, I see no reason why this industry recommendation cannot be applied to all client accounts included in a bunched order process. Certainly, assuring customer protections comparable to those afforded by recording the complete account identifier, as suggested by the Best Practices Report, should not be limited to certain types of accounts.

2 - Define allocation bias and require measurement of it with an appropriate accounting system. Specify what corrective action must be taken if it occurs.

Because there will be trade allocation differences, which could accumulate over time (i.e., bias), the proposed rule should be expanded to define what is meant by "consistently favorable" and "over time". With every method of trade allocation, except ones which assign on the basis of an average price, there will be financial differences in the impact of the allocations between the participating accounts. The systematic methods of allocation, discussed in the release, may often yield disparate results over time, because markets do not move in a systematic fashion. Markets may trend in an upward direction more quickly and in larger increments than they fall. This affects the difference between the execution prices of the trades and the average price for the bunch or block. The converse is also true. Even random allocation methods can be expected to yield disparate results, especially if the number of trades is not very large or as new accounts are opened or older ones are closed. (If, as recommended below, an average price system were used, there would be no need to track for bias.) The Commission should provide guidance in the rule as to what degree of bias it would consider immaterial, if any at all – and over what period of time this assessment should be made.

In order to ensure its rules prohibiting bias in trade allocations to be enforceable, I recommend the rule be enhanced to require the account manager or the FCM to measure (i.e., account for) trade allocation differences with an appropriate accounting system. The account managers should be required to make and keep a set of books and records which would show, for each bunched order, the differences between: i. the fill prices of the split fill trades allocated to each customer's account and; ii. the average of the split fill execution prices. (A "split fill" is defined as an order filled at two or more different prices.) This difference is the measure of the financial disparity between accounts caused by the allocation. Accumulating and

tracking these differences over time, across participating accounts, will permit assessment for bias, according to the specifications laid down by the Commission. This record should be required to be on file, for inspection by NFA auditors.

3 – Permit the use of average pricing systems as an alternative to accounting for and assessing the extent of allocation bias.

If split fills are to be allocated at the actual execution prices, the accounting system I recommend above will be required, if fairness of allocation is to be tracked. However, for those account managers who may wish a less burdensome alternative, I recommend the Commission permit them to use an average pricing system for trade allocation. With an average pricing system, no tracking of trade allocation results is needed. Average price systems result in equal sharing of the financial results of split fills. These systems can be used now, as explained below. (However, the use of average price systems does not obviate the need for controls over the order submission process, as explained in recommendation number 1 above.)

It should be noted that the Best Practices Report, on page 23, states: "Account managers should be encouraged to use average-price systems to assure non-preferential price allocations of split fills among the managers' customers". The rules of all of the U.S. exchange already permit the use of average price systems. Average price calculations can be performed by the either the clearing organizations' systems or the internal systems of the FCMs.

As a second possible alternative to the accounting system recommended above, the Commission could require that actual transfers of cash be made between the accounts of the participating customers, to achieve the same effect as average price allocations. This could be done by the account manager as part of his instructions to the FCM regarding the post execution allocation. This could be done if the participating customers agreed to it. The accounting system recommended above would be necessary to calculate the amounts of these transfers.

4 - Require account managers to review their own allocations for bias and file reports with NFA.

The proposed rule does not require the account manager to track for bias in his trade allocations, nor does it specify what should be done about bias, if it occurs. The industry Best Practices Report states on page 25: "If a registered account manager is responsible for the post-execution allocation of a bunched order, the account manager should develop internal *procedures* (emphasis added) pursuant to which its trading programs can be analyzed at regular intervals. The *results of such reviews* (emphasis added) should be documented and made available to appropriate regulatory or self-regulatory authorities upon request and/or to the money manager's own auditors."

Consistent with the industry's recommendation, I recommend that the proposed rule be changed to require the account manager to create a record of his review of his allocations of trades for bias. The record would be prepared from the information contained in the accounting system recommended above. This recommendation, for the preparation of a formal record to demonstrate compliance with a rule, is consistent with the Commission's approach in other important areas, such as in the net capital and segregation rules for FCMs.

Regarding what the permissive limits for bias in trade allocations should be set at, I would recommend that the limit be set at absolutely zero. I recommend that account managers be required to settle differences up on a monthly basis, by money transfer between the accounts which have participated in bunched orders. If bias is to be permitted, reporting to NFA of the amounts should be required on a routine basis.

5 - Require NFA to provide adequate audit coverage of trade allocations.

The present NFA audit program over account managers will not provide adequate coverage to enforce this rule. At present, NFA does not routinely audit all CTAs and it audits no foreign account managers at all. NFA schedules CTAs for audit on a "for cause" basis. This means NFA will schedule an audit of a CTA, if something comes to its attention that suggests an audit should be done. However, since the proposed rule requires nothing to be filed with NFA by CTAs, regarding allocation bias in bunched order trades, there never would be a "cause" for an audit to be conducted in this

regard. Therefore, CTAs should be required to file the above-recommended special reports with NFA, so that NFA can include this information in its "for cause" determinations for audit targeting of CTAs. If average price systems are used by an account manager, the carrying out of the computations and allocations could be checked during audits of the FCM. FCM audit coverage is much better than coverage of account managers.

As already stated above, account managers which are not registered with the Commission are not audited by NFA, such as the foreign account managers. In the futures industry's own Best Practices Report, on page 24, it is stated: "In Europe, in contrast to the U.S. allocation issues generally have not generated the same controversy or concerns, nor have they been a significant focus of regulatory activity. In this respect, the United States is *virtually unique* (emphasis added) in adopting order allocation procedures designed specifically to inhibit account managers, before the fact, from favoring certain customers to the detriment of others." Foreign customers, whose accounts are carried at a U.S. FCM, may believe their interests are being looked after by the regulators in the U.S. Under the proposed rule, this would be an unfounded hope. The lack of audit coverage plus the lack of controls, contained in the present proposal, is an open invitation to the abuse of foreign customers. As noted above, audit coverage of FCMs is much better than for account managers. Thus, this regulatory loophole would be closed, if average pricing systems were required and the FCM required the foreign account manager to file the short-code, as recommended above.

6 - As it is not useful as an indicator of bias, drop the requirement for a composite table.

The Commission should drop the requirement in the proposed rule for the distribution of the account manager's track record to customers, so they can monitor the fairness of trade allocations on their own. The track record is not at all useful for this purpose, because the returns of individual accounts included in a CTA's track record may vary greatly between one another (and usually do so). There are many reasons for this, unrelated to trade execution differences. The reasons for different returns between the accounts of customers include:

- composites may include accounts which were only traded for part of a month, due to being opened or closed during the month;
- some accounts may not get the same proportional number of trades as other accounts, due to split fills or being smaller than the other accounts;
- some accounts may be charged different percentage amounts of management and incentive fees; commissions charged by the FCM may differ between accounts;
- newly opened accounts may be charged an incentive fee whereas accounts which have not yet recovered from prior net losses would ordinarily not be charged any incentive fee;
- accounts which contain larger margin deposits than others would reflect a greater amount of interest income in their net performance than the other accounts with less margin on deposit; and
- some accounts may not have been traded at all for a time or a particular month, at the request of the customer or because the customer had not satisfied margin calls.

The Commission already acknowledges the variability of returns of accounts contained in a composite, because in its rule proposal release regarding CTA performance issues, which has just closed for comment, the Commission stated that: "A variety of factors, including, but not limited to, differences due to trade execution, fees, commissions, and the timing of opening or closing accounts, may have an impact on the returns for individual accounts." The release also states that material differences amongst accounts included in the same composite must be *discussed* (emphasis added) by the CTA. These complications make the track record useless as a tool to measure or track bias in the allocation of bunched trades.

I appreciate having had the opportunity to share my views with the Commission.

Very truly yours,

Paul H. Bjarnason, Jr.