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COMMENT

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Ms. Jean A. Webb
Secretary to the Commission
Commodity Futures Trading Commission
1155 21ST Street NW
Washington DC 20581

Re: Proposed Amendments to Rule 1.35(a-1)(5)—Post-Execution Allocation of Bunched Orders, 68 *Fed.Reg.* 12319 (March 14, 2003)

Dear Ms. Webb:

The Futures Industry Association ("FIA") welcomes this opportunity to comment on the Commodity Futures Trading Commission's ("Commission's") proposed amendments to rule 1.35(a-1)(5), 68 *Fed.Reg.* 12319 (March 14, 2003).[1] The amendments modify the terms and conditions pursuant to which eligible account managers may allocate by the end of the trading day the futures and options on futures contracts executed in one or more bunched orders entered on behalf of multiple clients.

The proposed amendments strike an appropriate balance—modifying terms and conditions of the existing rule that have proved in practice to be unnecessarily cumbersome for futures industry participants, while maintaining procedural requirements that will permit the Commission and the several self-regulatory organizations to meet their responsibilities of assuring continued customer protection. The proposed amendments, therefore, represent another important milestone in the Commission's efforts to revise the regulations governing Commission registrants to reflect more accurately the changing market environment. FIA encourages the Commission to promulgate the amendments as proposed.

Evolving Regulatory and Market Environment

The Commission first set out a rule governing the execution of bunched orders that an account manager places on behalf of multiple clients in an Interpretation issued in 1997.[2] This

[1] FIA is a principal spokesman for the commodity futures and options industry. FIA's regular membership is comprised of approximately 40 of the largest futures commission merchants ("FCMs") in the United States. Among its associate members are representatives from virtually all other segments of the futures industry, both national and international. Reflecting the scope and diversity of its membership, FIA estimates that its members effect more than eighty percent of all customer transactions executed on United States contract markets.

[2] 62 *Fed.Reg.* 25470 (May 8, 1997). The Interpretation constituted a formal acknowledgment of the longstanding policy of the Commission and its staff with respect to bunched orders.

Interpretation incorporates an Interpretive Statement issued by the National Futures Association ("NFA"), which offers guidance to Commission registrants on complying with the Commission's Interpretation. In brief, NFA's Interpretive Statement requires commodity trading advisors to furnish FCMs with sufficient information that identifies the accounts included in the bunched order and the number of contracts to be allotted to each account at or before the time a bunched order is placed. The account manager's allocation instructions must also take into account the possibility that a bunched order may only be partially filled or may be filled at different prices.[3]

The regulatory rationale underlying the general rule is the belief that an account manager's clients are better protected when the manager must determine the manner in which executed contracts are allocated among its clients before the order is executed. This pre-execution allocation requirement is intended to deny an unscrupulous manager the ability to allocate trades improperly among its clients, favoring some to the disadvantage of others. However, as explained below, it also may deny all account managers the ability to achieve equitable trading results for their clients, in particular when the manager's trading strategy involves multiple markets.

When the Commission first interpreted its rules to permit account managers to place bunched orders on behalf multiple clients, the regulatory and market environment was relatively simple.[4] Account managers' trading strategies were comparatively straightforward. Moreover, the clients the Commission sought to protect were primarily retail customers.

Since then, however, the environment has changed dramatically. The class of account managers has expanded to include banks, insurance companies, investment advisers and foreign advisers. Their clients include investment companies, pension plans, hedge funds, multinational corporations and governmental entities. As important, trading strategies have become far more complex. Highly sophisticated software programs allow account managers to trade multiple products, including exchange-traded and over the counter equities, equity options, interest rate products and foreign currencies, across markets globally. These programs are dynamic, rapidly

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[3] In the *Federal Register* release accompanying the proposed amendments, the Commission requests comment on whether this Interpretation and NFA's Interpretive Statement should be modified in any way in light of the amendments. FIA believes that the proposed amendments effectively rescind significant portions the Interpretation and the Interpretive Statement. Therefore, if the amendments are adopted, we would encourage the Commission to take appropriate action to make clear that the standards set forth in amended rule supercede any guidance in either the Interpretation or the Interpretive Statement that may be inconsistent. . If the Commission or NFA subsequently determine to revise its interpretation, we would be please to assist in this effort.

[4] In a 1993 *Federal Register* release in which the Commission first proposed amendments to rule 1.35(a-1) to authorize post-execution allocation of bunched orders, the Commission cited cases dating to 1983, which confirmed that both "the Commission and the courts have accepted the use of allocation formulas for properly documented bunched customer orders." 58 *Fed.Reg.* 26270, fn. 7 (May 3, 1993).

adjusting the mix of products that an account manager may trade throughout the day in response to market events.

Although these programs are able to determine the products and number of contracts to be traded, they cannot always determine the allocation among clients until well after the trade has been executed. In order to avoid missing the market, responsible account managers would want to execute the order before the allocation instructions are generated. Moreover, trading restrictions adopted by certain clients (such as exclusion of particular products or instruments) could require a manager to adjust the allocation.

As important, the Commission's rules requiring pre-execution allocation of contracts denied account managers the flexibility they need to fulfill their fiduciary responsibilities to their clients. A bunched order allocated pursuant to a pre-execution program may, standing alone, appear fair to all clients. When combined with all other products an account manager has traded on behalf of its clients that day, however, those contracts may actually skew the results, treating one or more clients more favorably than others.

The Current Rule

To address these concerns and to "encourage and facilitate institutional participation in the futures markets subject to customer protection requirements that were consistent with the sophistication of the institutional customers", the Commission, in August 1998, adopted rule 1.35(a-1)(5) authorizing the use of post-execution allocation procedures in carefully prescribed circumstances.[5] Specifically, the class of eligible clients whose orders may be subject to post-execution allocation procedures is limited to persons that now generally fall within the definition of an "eligible contract participant" under section 1a(12) of the Commodity Exchange Act ("Act"). The Commission concluded that these persons are sufficiently sophisticated to monitor the results of any post-execution allocations in their accounts. Further, the class of eligible account managers is limited to banks, insurance companies and entities registered with the Commission or the Securities and Exchange Commission as commodity trading advisors and investment advisers, respectively.[6]

[5] 63 *Fed.Reg.* 45699 (August 27, 1998). The Commission stated that the procedures were designed, in part, to permit eligible account managers "to achieve equivalent results for eligible customer accounts being traded pursuant to strategies involving trading activity in more than one market."

[6] A foreign adviser may also be an eligible account manager, if the adviser is subject to regulation by a regulatory or self-regulatory authority that has been granted an exemption pursuant to Commission rule 30.10. In addition, the adviser must provide the FCM clearing any part of the order a written certification from the authority stating that the adviser's activities are subject to regulation and that the authority will provide the Commission or the Department of Justice, upon request, information that relates to the adviser's compliance with the requirements of the rule. Foreign advisers have found this aspect of the rule to be particularly onerous, since it effectively asked foreign regulators to confirm to a Commission registrant that they would assure compliance with Commission regulations by the foreign adviser.

To help assure compliance with the rule, an account manager must provide each FCM that clears any portion of an order a written certification that identifies each eligible customer account to which fills may be allocated and, in addition, confirms that the account manager "is aware of, and will remain in compliance with, the requirements" of the rule. The account manager must also create and maintain records concerning its trading activities on behalf of eligible clients. These records should reflect "futures and option transactions and any other records, including the order origination document, that would identify the management strategy or allocation methodology or would relate to, or reflect upon, the fairness of the allocations." In this latter regard, the rule further provides that the manager's allocation methodology "must be sufficiently objective and specific so that the appropriate allocation can be verified in an independent audit."

Best Practices Recommendations

The year following the adoption of rule 1.35(a-1)(5), the Commission requested the National Futures Association and the Futures Industry Institute to undertake an "industry-wide study of issues associated with order transmission and entry procedures for exchange-traded futures and options and the diligent supervision of the order transmission and order entry process by commodity professionals." The resulting report, *Recommendations for Best Practices in Order Entry and Transmission of Exchange-Traded Futures and Options Transactions*, was released in February 2001. Among its recommendations, the report concluded that the "benefits of post-execution allocation procedures should be extended to all customers of account managers" when the following conditions are met:

- The account manager is registered or otherwise subject to appropriate regulation;
- The account manager has adopted and implemented an equitable allocation scheme that is sufficiently objective and specific to permit independent review of such procedures by the appropriate regulatory or self-regulatory authorities and the account manager's accountants;
- The account manager makes available to its customers the general structure and nature of its allocation method; and
- The account manager allocates all transactions among its customers no later than the end of the trade date.

As the report notes, "by affording an account manager the opportunity to place orders for all of its customers at one time, a bunched order assists an account manager in the exercise of its fiduciary responsibility to treat all customers fairly and equally."[7] The report further notes:

[7] *Recommendations for Best Practices in Order Entry and Transmission of Exchange-Traded Futures and Options Transactions*, p. 25. The report also recommends that account managers "be encouraged to use an

> Best practices in the area of bunched orders must provide customer protections equivalent to those currently in place. To assure that an account manager's bunched order allocation procedures are fair and equitable, best practices require that such processes be sufficiently objective and specific to permit independent review of any trade or series of trades that involves bunched orders. . . . [T]he account manager should develop internal procedures pursuant to which its trading programs can be analyzed at regular intervals. The results of such reviews should be documented and made available to appropriate regulatory or self-regulatory authorities upon request and/or to the money manager's own auditors.
>
> If there is evidence of divergent performance among client accounts over time, the account manager must be able to demonstrate to the appropriate authorities that such results are attributable to factors other than the account manager's trade allocation or execution procedures. . . . Further, account managers should be required to disclose the general structure and nature of their allocation methods to their customers.

The Proposed Amendments

The proposed amendments are consistent with the recommendations contained in the report. In particular, the procedures set forth in the amendments will continue to assure customer protection. For example, paragraph (iii)(C) of the rule provides that the "allocation methodology must be sufficiently objective and specific to permit independent verification of the fairness of the allocations using that methodology by appropriate regulatory and self-regulatory authorities and by outside auditors." Indeed, in the event questions arise, the account manager would have the burden of establishing that its allocation methodology is fair.

Moreover, the recordkeeping requirements to which account managers and FCMs will be subject will permit the relevant regulatory and self-regulatory authorities to conduct audits of account managers to confirm that they are conducting their trading activities in accordance with the requirements of the rule. Among other documents, account managers are required under paragraph (iv)(B) to maintain records that are "sufficient to demonstrate that all allocations meet the standards of . . . this section and to permit the reconstruction of the handling of the order from the time of the handling of the order from the time of placement by the account manager to the allocation to individual accounts." [8]

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average price system to assure non-preferential price allocations of split fills among the managers' customers." FIA supports this recommendation. However, an average price system does not negate the need for post-execution allocation procedures. For the reasons described above, an account manager must have the flexibility to allocate the number of contracts among its clients.

[8] Paragraph (iii)(A) further requires account managers to "provide allocation information to futures commission merchants no later than a time sufficiently before the end of the day the order is executed to ensure

For their part, in addition to the recordkeeping requirements to which FCMs generally are subject under the Commission's rules, FCMs that execute or carry accounts with respect to which transactions will be eligible for post-execution allocation must "maintain records that, as applicable, identify each order subject to post-execution allocation and the accounts to which contracts executed for such order are allocated."[9] Therefore, although the format of the records that account managers and FCMs will be required to maintain may change, the records required to be maintained under the proposed amendments will be no less adequate to allow the relevant regulatory and self-regulatory authorities to conduct audits to assure compliance with the rule for the protection of the account manager's clients.

The proposed amendments also successfully address various aspects of the current rule that account managers have found inhibit the fair and efficient execution of orders, without diminishing customer protection. For example, by extending the benefits of post-execution allocation to all market participants, the proposed amendments eliminate the potential disparity in quality and timing of execution that non-eligible clients currently face. Similarly, the class of eligible account managers has been expanded to include managers that are excluded or exempt from registration with the Commission or the applicable securities regulatory authority. Both the Commission and the Securities and Exchange Commission exempt or exclude certain account managers from registration based on the limited scope of the manager's activities or the nature of its clients. (Exclusions or exemptions from registration generally are not available to account managers with retail clients.) Since the relevant regulatory agencies have determined that these managers are not otherwise required to be registered in order to engage in trading activities on behalf of clients, FIA believes it is appropriate that they should be permitted to take advantage of post-execution allocation procedures without registration.[10]

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that the clearing records identify the ultimate customer for each trade." The description of this provision in the accompanying *Federal Register* release, however, differs slightly, stating that the allocation must be made before the end of the "trading session" rather than the "end of the day" during which the order is executed. This difference appears to be unintentional. In the *Federal Register* release accompanying the final rule, we ask the Commission to confirm that allocation information must be provided no later than the "end of the day" during which the order is executed.

[9] Paragraph (iv)(C). In this regard, we note, for example, that FCMs generally receive allocation instructions by facsimile or e-mail and, therefore, will have a record of the time that allocation instructions are received as well as any subsequent modifications to those instructions. Similarly, to the extent allocation instructions may be made through electronic systems, the time at which the instructions are received will be recorded.

[10] It is important to note that, although certain account managers may not be required to be registered, they nonetheless remain subject to regulation by the appropriate regulatory and self-regulatory authorities and to applicable law, including the applicable provisions of law prohibiting fraud.

The Commission's proposal to remove the required certifications also has no adverse effect on customer protection. The sole purpose of the certification was "to assure that the account manager, who has overall responsibility for compliance with the eligible order provisions, was cognizant of, and would comply with, the provisions."[11] The elimination of the certification does not alter the account manager's continuing obligation in this regard. It does, however, confirm that the obligation to assure that allocations are fair and equitable rests with the account manager and not with the FCMs that clear the clients' accounts. The required certifications have been viewed by some to imply that FCMs have a responsibility to assure that account managers are fulfilling their fiduciary obligations to treat their clients fairly. Certainly, FCMs have an obligation to monitor their clients' accounts for unusual account activity. However, in the absence of such activity, FCMs simply do not have the ability to assess whether an account manager is treating its clients fairly. Only the account manager has all of the records and other information that permit such an analysis.[12]

This is particularly true today. The wide use of give-up arrangements means that an account manager's transactions on behalf of its clients frequently are executed through one FCM and later cleared through several different FCMs. Moreover, with the increased use of electronic order entry systems, account managers are able to place trades directly for execution. An FCM, therefore, may have no reason to know that an order has been executed for a client's account until the transaction has been executed and cleared. Finally, a manager may be trading different types of products for its clients, including securities, foreign currency and cash commodities. These products and the records relating to them may not be held at an FCM at all, but may be carried at a broker-dealer or bank. Consequently, an FCM has an incomplete picture of an account manager's trading activities on behalf of its clients and has no ability to make any judgments with respect to the fairness of such trading.[13]

Conclusion

For the reasons discussed above, FIA believes that the amendments will permit the Commission and the several self-regulatory organizations to meet their responsibilities of assuring customer protection, while modifying those terms and conditions of the existing rule that have proved in practice to be unnecessarily cumbersome. We, therefore, urge the Commission to adopt the

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[11] 63 *Fed.Reg.* 45699, 45703 (August 27, 1998).

[12] As discussed above, however, FCMs will have records that will assist the relevant regulatory and self-regulatory authorities in their audits of account managers.

[13] Further, account managers that are not Commission registrants have objected to the requirement that they make the disclosures set forth in subparagraph (iii) of the rule. As otherwise regulated entities, they believe that the laws and regulations to which they are subject adequately govern their disclosure and other fiduciary obligations to their clients. Although the proposed amendments remove the disclosure requirement, account managers nonetheless continue to have the obligation to make comparable information available to their clients.

amendments as proposed. If the Commission has any questions concerning the comments in this letter, please contact Barbara Wierzynski, FIA's General Counsel, at (202) 466-5460.

Sincerely,

John M. Damgard
President