NFA NATIONAL FUTURES ASSOCIATION

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(17)

COMMENT

April 28, 2003

<u>Via E-Mail (Secretary@cftc.gov)</u>

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

> Re: Account Identification for Eligible Bunched Orders, 68 *Fed. Reg.* 12319
>   (March 14, 2003)

Dear Ms. Webb:

All customers deserve to have their orders filled efficiently and at the most favorable terms available under the circumstances. CFTC Rule 1.35(a-1)(5) currently allows account managers to achieve this objective for institutional customers by bunching their orders but denies these same advantages to many retail customers. The amendments proposed by the Commission will permit retail customers to enjoy the same advantages as sophisticated customers by facilitating the prompt execution of small orders at a beneficial price. Further, the proposed change includes protections that will provide for fair and equitable trade allocation for all customers, allowing them to share the benefits of bunched orders without sacrificing any customer protection.[1]

The Commission's proposal also extends these benefits to customers of account managers who are exempt from registration as, or excluded from the definition of, a CTA or investment adviser. In these instances, either Congress, the Commission, or the Securities and Exchange Commission has made a reasoned decision that the

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[1] The proposed amendments are consistent with the recommendations in the Best Practices Report prepared by NFA and the Futures Industry Institute. *Recommendations for Best Practices in Order Entry and Transmission of Exchange-Traded Futures and Options Transactions*, pp. 23-26 (February 2001).

account manager's customers do not require the protections provided by registration under the Commodity Exchange Act or the Investment Advisers Act of 1940 (e.g., because the customers are sophisticated or the account manager is subject to another regulatory scheme). Therefore, NFA believes that it is appropriate to permit these entities to act as eligible account managers. Additionally, we believe that the protections contained in the proposed amendments, coupled with the Commission's anti-fraud and anti-manipulation authority, should be sufficient to protect their customers from receiving unfair allocations.

NFA agrees with the Commission that the fairness of allocations – as opposed to whether the allocation methodology is followed – should be judged over time rather than on an order-by-order basis, and this approach is consistent with the Best Practices Report. Therefore, we support the amendments that adopt this standard.

Additionally, we support the proposed amendments clarifying that the account manager – rather than the FCM – is responsible for ensuring that the allocation is done correctly. Unlike the FCM, the account manager is aware of positions held at more than one FCM. Further, the use of electronic order routing and execution systems permit account managers to place orders directly for execution, making it harder for FCMs to monitor such transactions prior to execution and clearing. Therefore, the account manager is in a better position to ensure fair allocations.

The Commission's proposal does, however, impose recordkeeping requirements on both account managers and FCMs. Account managers are required to keep records that demonstrate their compliance with the requirements in the rule and that allow an auditor to reconstruct a trade from order entry through allocation, and FCMs are required to keep records showing which orders were subject to post-execution allocations and the accounts that were included in the allocation. Furthermore, under NFA requirements, FCMs with actual or constructive notice of unusual account activity, including fraudulent allocations, would be responsible for making a reasonable inquiry into the matter and referring it to the proper regulatory authorities if appropriate.[2]

The recordkeeping requirements, coupled with the requirements regarding allocation methodologies, ensure that the fairness of the allocation system – and whether it is followed – can be audited. NFA tests these methodologies and their application as part of our regular CTA audits.

NFA is aware that the Commission has received a comment letter criticizing NFA's audit program for CTAs and stating that NFA does not routinely audit all CTAs. That commenter is clearly misinformed. NFA schedules CTA audits using a risk-based auditing system that incorporates a regular auditing cycle. Under this cycle,

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[2] *See* Interpretive Notice to NFA Compliance Rule 2-10: The Allocation of Block Orders For Multiple Accounts (¶ 9029, NFA Manual).

CTAs that manage accounts for retail customers are audited at least once every three years, and CTAs that are inactive or that manage accounts for sophisticated customers are audited every 4-5 years. Furthermore, because NFA uses a risk-based auditing system in addition to regular exam cycles, the existence of certain factors – such as customer complaints – causes NFA to audit a CTA sooner. Obviously, any complaint involving fraudulent allocations will result in an immediate examination by NFA.[3]

NFA currently has two interpretive notices regarding bunched orders, and those notices will have to be rescinded or amended if the Commission adopts the proposed amendments to Rule 1.35. The Interpretive Notice to NFA Compliance Rule 2-10: Orders Eligible for Post-Execution Allocation (¶ 9036, NFA Manual) will no longer apply and will be rescinded. We will also amend the Interpretive Notice to NFA Compliance Rule 2-10: The Allocation of Block Orders for Multiple Accounts (¶ 9029, NFA Manual) to make it consistent with the Commission's rules and to provide guidance relating to the use of bunched orders. In doing so, we intend to retain many of the important protections that notice currently provides. For example, we anticipate that the notice will continue to:

- Require CTAs to use an allocation methodology designed to provide non-preferential treatment for all accounts (the specific allocation instructions may change daily based on certain factors, but the allocation methodology should not);

- Provide guidance on the type of allocation methodologies designed to provide non-preferential treatment;

- Require CTAs to regularly analyze each trading program to ensure that the allocation method has been fair and equitable and to document this analysis; and

- Remind FCMs that they have certain basic duties to their customers in connection with these orders.

The proposed amendments to Commission Rule 1.35 will benefit customers by ensuring that their orders will be filled efficiently and at the most favorable terms available under the circumstances. The proposal includes a number of requirements specifically designed to protect customers from unfair allocations (e.g., by requiring account managers to use an objective, auditable allocation methodology and to disclose certain information upon request that allows customers to analyze account performance). The proposed amendments will also benefit the industry by eliminating several unnecessary and sometimes cumbersome requirements. In short, the Commission's proposal will benefit customers, account managers, and other industry

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[3] We note that the Commission has audited our compliance procedures – including our audit programs – a number of times over the past 20 years and has always found that they are reasonably designed and applied to detect and deter violations of NFA and CFTC requirements.

participants by quickening market access and streamlining order flow without sacrificing customer protection.

NFA encourages the Commission to adopt the amendments as set forth in the *Federal Register* release. If the Commission has any questions regarding the comments in this letter, please contact me at (312) 781-1413 or tsexton@nfa.futures.org .

Respectfully submitted,

Thomas W. Sexton
Vice President and General Counsel

(kpc/Comment Letters/Bunched Orders)