

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

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COMMODITY FUTURES
TRADING COMMISSION
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Re: Reproposed Amendments to Commodity Futures Trading Commission
Regulation 1.35 Relating to Account Identification for Eligible Bunched
Orders

Dear Ms. Webb:

National Futures Association ("NFA") welcomes this opportunity to submit the following comments in response to a release issued by the Commodity Futures Trading Commission ("Commission" or "CFTC") on January 7, 1998.¹ That release requested comments on the Commission's repropose amendments to CFTC Regulation 1.35 relating to account identification for eligible bunched orders. The comments contained in this letter are derived after numerous discussions among members of a subcommittee of NFA's Special Committee for the Review of a Multi-Tiered Regulatory Approach. Members of this subcommittee and NFA staff have also met with Commission staff and members of both the Futures Industry Association and Managed Funds Association to discuss these comments.

NFA applauds the Commission's efforts in repropose amendments to Regulation 1.35 that, subject to certain core regulatory protections, permit a limited number of regulated account managers to place orders for a defined group of sophisticated eligible customers without providing specific customer account identification at the time of order placement. NFA notes that the CFTC's proposed amendments to Regulation 1.35 attempt to balance two significant goals – to facilitate efficient access to the futures markets for sophisticated customers who have managed accounts while, at the same time, providing adequate protection against fraudulent misallocations of trades. However, while NFA strongly endorses both of these goals, NFA also believes that the potential universe of eligible managers and customers should be expanded to include other appropriately qualified persons. At the same time, NFA believes that additional, and in some cases, alternative measures should be implemented to help ensure that only managers that are

¹ 63 Fed. Reg. 695 (1998).



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willing to formally commit to allocating orders in a fair, non-preferential and verifiable manner are eligible to take advantage of the Commission's proposed relief. NFA adopts this position because it believes that, if the Commission agrees with the industry that post-trade allocation is sometimes a more efficient way of processing bunched orders, the maximum number of persons reasonably possible should be permitted to take advantage of such a process. This is because a system that is fundamentally fair and verifiable is fair and verifiable for all, not for some.

In the first instance, NFA believes that the Commission's repropoed amendments could be more expansive with regard to both the types of eligible participants and eligible orders.

Eligible Account Managers

In general, while NFA believes that the Commission's proposed list of eligible account managers is extensive, it does not include one category of manager - - foreign advisors - - that also requires and should be able to take advantage of the Commission's proposed relief. The Commission provides no explanation for this exclusion which appears particularly problematic because, to the extent these advisors service non-U.S. persons, the Commission has historically not extended its regulatory umbrella to such relationships. Given the significant role of foreign advisors in the financial markets, NFA feels that proposed Regulation 1.35(a-1)(5)(ii)'s listing of eligible account managers should also include these advisors.

Eligible Customers

NFA also believes that repropoed Regulation 1.35(a-1)(5)(iii)'s listing of eligible customers should include certain natural persons. In its release, the Commission notes that the proposed list of eligible customers is substantially similar to those entities defined as "eligible participants" in the CFTC's Part 35 and 36 regulations. The Commission also states that it included these entities in its list of eligible customers because they are sufficiently sophisticated to monitor post trade allocations in their accounts. Although deciding to omit natural persons from the listing of eligible customers, the Commission admits that certain natural persons may have this requisite sophistication level. If the true test to constitute an eligible customer is an entity or person's sophistication level to monitor post trade allocations, then NFA encourages the



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Commission to include certain natural persons, as defined in CFTC Regulations 35.1(b)(2)(xi) and 36.1(c)(2)(xi), in its listing of eligible customers.²

NFA also encourages the Commission to add natural persons to its listing of eligible customers for a very practical reason. To the extent that the Commission carves a limited exception -- natural persons -- to the listing of eligible customers, then eligible account managers may experience operational difficulties taking advantage of proposed Regulation 1.35(a-1)(5)'s relief. Obviously, inherent in the proposed rule, eligible account managers will be permitted to place a bunched order and allocate post execution for some customers but not others. As a result, an account manager will be forced to place multiple bunched orders for customers in the same trading program. The per se exclusion of all natural persons, regardless of their sophistication level, unnecessarily increases the complexity of the order process. In addition, although trades for a natural person's account could not be allocated post execution under the Commission's current proposal, that same natural person could be the sole shareholder of a corporation, with net worth exceeding \$1,000,000 or total assets exceeding \$10,000,000, and constitute an eligible customer. This anomaly further evidences the inappropriateness of excluding natural persons.

Eligible Orders

NFA also suggests that the Commission reconsider the proposed restrictions regarding the permissible extent of proprietary ownership by the account manager or futures commission merchant of any accounts included in the block order and the requirement that the trading portfolio must include non-futures related instruments. If the allocation procedures satisfy the core fairness principles outlined below, then it should not matter that proprietary accounts are included in the block order.³ This is the same

² NFA notes that the Commission's recently approved amendments to Regulation 1.55 contain another definition of "sophisticated customer", which includes natural persons. NFA believes that the inclusion of more than one definition of "sophisticated customer" in the Commission's regulations is very confusing. Accordingly, NFA will be separately submitting a request to the Commission to provide for a uniform definition of "sophisticated customer" in Commission Regulation 1.3. The Commission and NFA as regulators should provide clearer guidance to the industry by adopting one definition of "sophisticated customer" for all purposes.

³ NFA notes that in adopting the LOX rules, the CFTC considered a similar issue and decided under limited circumstances that it may be possible to combine proprietary and customer trades within one order. See CFTC Regulation 1.39(b).



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approach that NFA adopted and the Commission approved in NFA's Interpretive Notice Relating to the Allocation of Block Orders for Multiple Accounts. NFA felt then and feels now that it is not sound regulatory policy to discourage account managers from putting their own money at risk in the same trades they make for their customers.

NFA also notes that many institutional customers desire their advisors to trade their own funds just like the customers' funds. In fact, NFA believes that permitting the intermingling of customer and proprietary orders in a bunched order may facilitate the detection of allocation abuses. If the test of fairness is near equivalency in results, proprietary accounts that consistently perform better than customer accounts will be inherently suspect.

Moreover, applying a percentage test to determine when an eligible account manager qualifies to use the Commission's proposed allocation procedures could prove administratively burdensome. For example, if a CPO/CTA sponsors a closed-end customer fund, the CTA might normally be eligible to take advantage of the Commission's proposed allocation procedures regarding that account. But, during those intervals when the CPO might be obligated to redeem shares, resulting in either a temporary or a long term interest in the fund of more than 10%, the fund would not be permitted to take advantage of the procedures. Permitting an eligible account manager to sometimes take advantage of the Commission's proposed relief, but not other times, could cause logistical problems (issuing and revoking certifications, see below) that do not significantly add to customer protection.

The Commission also proposes that only eligible account managers trading a mixed portfolio be permitted to take advantage of its proposed allocation procedures. The NFA urges the Commission to reject this limitation. If a manager allocates orders in a fair, non-preferential and verifiable manner, then there should be no limit upon the types of orders to be allocated. Although the original request for relief resulted from the difficulties confronted by investment advisors trading mixed portfolios of securities and futures contracts, the same difficulties are encountered by advisors who trade futures on behalf of numerous customers during volatile markets.⁴

⁴ To the extent that the Commission suggests that proposed Regulation 1.35 (a-1)'s relief should not apply to futures only transactions due to the availability of an average pricing system, the CFTC neglects several important points. First, APS is not universally available on all exchanges. Second, APS is designed to deal with split fills but not with the more important question of how the total number of contracts should be allocated to the various accounts included in the block order.



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Trading advisors who trade esoteric volatility spreads, who arbitrage, or who otherwise trade combinations of different futures and options contracts (e.g. different commodities, different months in the same commodity, or in the case of options, different strike prices) confront the same pressures of time and fairness when they are forced to advise executing brokers in advance of a trade regarding the identity of each and every customer. The better practice is to let the advisor allocate the trades on an equitable and non-discriminatory basis after the fact. As a further example, large sophisticated advisors with a large futures only order to be executed may elect to place a series of orders during the course of a day to alleviate the impact of one order upon market prices. With regard to the allocation of these orders, it may not be practicable to pre-file with the FCM a standing set of allocation instructions. The trading programs used by these advisors are complex and dynamic. Given the fine tuning adjustments (e.g. restrictions on leverage, intraday redemptions and limits on futures/options exposure) that are made on a daily basis, the exact number of contracts these advisors allocate to any given account may vary from one day to the next. Likewise, these advisors do not wish to contemporaneously file allocation instructions because their entire order size is then disclosed. Therefore, these advisors should be permitted to obtain the relief offered by proposed Regulation 1.35(a-1)(5). The mixed portfolio requirement adds no further protections for customers and fails to recognize that trades in different futures markets present the same allocation issues for eligible account managers as do intermarket orders. Moreover, any account manager trading a futures only portfolio will be an NFA Member CTA. NFA's existing audit programs specifically address fraudulent allocation issues and are designed to detect this type of abuse. Ironically, the accounts getting the most scrutiny and that are subject to the greatest regulation by the CFTC and NFA will be the ones excluded.

Strengthened Customer Protection

NFA believes that the protections required by the Commission for an eligible account manager to use the Commission's proposed allocation procedures provide customers with significant protections. In particular, NFA strongly supports proposed Regulation 1.35(a-1)(5)(vi)(E) which requires each account manager to make available data sufficient for customers to compare their results with those of other relevant customers. NFA believes that this is an important regulatory safeguard designed to help eligible customers, including individuals, monitor post trade allocations.⁵

⁵ NFA agrees with the Commission that performance records used for this purpose should not disclose the identity of the trading manager's individual account holders. NFA requests that the Commission clarify that trading managers can satisfy this obligation by making performance data available, without making any underlying source documents available to the customer.



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Likewise, NFA strongly supports the Commission's proposal that eligible account managers represent in writing that they are aware of and will comply with Regulation 1.35(a-1)(5)'s requirements⁶. However, NFA believes that this representation should be made by the eligible account manager to the clearing FCM allocating the eligible account manager's trades to the ultimate customers and not to "each FCM executing and/or allocating any part of the order" as proposed by the Commission⁷. The "and/or" alternative could create confusion and it should be sufficient if such representation is made to the clearing FCM only. NFA also recommends that the Commission clearly articulate that this representation once made is perpetual unless revoked.

NFA believes that proposed Regulation 1.35 (a-1)(5) should also be amended to require eligible account managers to describe in general terms their basic approach to allocating trades among participants in a particular trading program and that this approach provides fair and equal treatment. Although NFA does not believe that such representations need to be in a prescribed format, they should, at a minimum, provide customers with the understanding that the methodology is (i) non-preferential (such that no account or group of accounts receive consistently favorable or unfavorable treatment), (ii) sufficiently objective and specific that the appropriate allocation for any given trade can be verified in any independent audit and (iii) consistently applied by the account manager. None of these requirements are intended to require any account manager to disclose any proprietary information regarding its trading strategies or operations.

NFA also believes that each eligible account manager should be required to represent to its eligible customers that it regularly reviews each eligible account to ensure that its allocation method has been fair and equitable. Obviously, if material divergent performance results exist over time that are not attributable to factors other than the manager's trade allocation procedures, then the manager would be expected to either change its allocation method to ensure fairness or withdraw its representations to its customers and FCM, thereby becoming ineligible for Regulation 1.35 (a-1)(5)'s relief.

⁶ NFA requests that the Commission amend proposed Regulation 1.35 (a-1)(5)(iv)(A)'s language to delete the legal term "certify" and replace it with "represent".

⁷ As you are aware, pursuant to NFA's Interpretive Notice Relating to the Allocation of Block Orders for Multiple Accounts, CTAs are required to file a certification with NFA in order to contemporaneously file allocation instructions. If the CFTC were to request NFA to perform a similar function with regard to the representation required by proposed Regulation 1.35(a-1)(5), NFA would be willing to act as a repository for these certifications.



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Finally, the manager should also be required to represent that it will document the internal procedures and results of its regular analysis and maintain these procedures and results as firm records at least as required under applicable law. In the case of an eligible account manager under the oversight of the Commission, these documents would be subject to review during examination by its regulator.⁸ For NFA Members, NFA as part of its examination of the firm will review the results of this analysis. NFA strongly believes that requiring eligible account managers to perform this analysis provides a greater degree of protection to eligible customers.⁹

Moreover, NFA believes that the requirement that eligible account managers make the aforementioned representations directly to customers is consistent with the philosophical basis for granting the Commission's proposed relief: sophisticated clients will benefit by having their CTAs execute orders more efficiently which will be allocated after the fact in a fair and non-discriminatory fashion. This is a private matter between sophisticated clients and their advisors that should not be subject to oversight by FCMs, absent ordinary obligations of the FCMs arising under Commission Regulation 166.3. Additionally, customers potentially gain a valuable tool in circumstances where an allocation scheme is fraudulently applied: the customers have written evidence of a material misstatement of fact that could be used to help buttress a private action for fraud.

Other Issues

NFA encourages the Commission to delete the proposed regulation's "end of the day" phraseology and replace it with "post-execution allocation." NFA strongly believes that, along with that change in phraseology, it would be helpful for the Commission to indicate that account managers availing themselves of proposed Regulation 1.35(a-1)(5)'s relief should provide allocation information as soon as practicable after the entire transaction is executed but not later than the end of the day. NFA suggests that the Commission clarify that "end of the day" may be defined by certain contract market or FCM operational timetables. Along with this guidance, NFA encourages the Commission

⁸ For other eligible account managers, such records would be maintained as ordinarily required under applicable law. Other regulators could choose to make use of these records as they saw fit applying their particular standards.

⁹ Since the required representations by advisors to customers will be set forth in Rule 1.35(a-1)(5), the advisor's representation to the FCM regarding compliance with the Rule will incorporate those representations by reference and therefore need not include a restatement of the representations.



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to require eligible account managers to state, as part of the representations to customers discussed above, that they will provide allocation information as soon as practicable after an entire transaction is executed but no later than as required by certain contract market and/or FCM operational timetables. Additionally, while NFA realizes that in certain limited circumstances it may not be practicable for an account manager to provide allocation information immediately after the entire transaction is complete, NFA believes that such delays should be neither commonplace nor lengthy, and the account manager should be required to maintain appropriate documentation whenever such delays occur.

Further, NFA believes that certain aspects of the Commission's proposal do not add significant protections and should be eliminated. For example, although we agree that adequate disclosures to eligible customers are essential, requiring account managers to obtain signed acknowledgements from these sophisticated customers appears inconsistent with the Commission's proposed amendments to Regulation 1.55, which eliminate the requirement for a written acknowledgement of risk disclosure by sophisticated customers. NFA recommends that re-proposed Regulation 1.35(a-1)(5)(iii)(A) be amended to require instead that eligible account managers provide written disclosure to their eligible customers relating to Regulation 1.35(a-1)(5)'s requirements. Furthermore, once these disclosures are made, it would seem redundant and add unnecessary technical requirements for proposed Regulation 1.35 (a-1)(5)(vi)(C) to require that each confirmation statement identify trades subject to post execution allocations. Additionally, in certain transactions, complying with this requirement may not be operationally possible. For example, in give-up transactions, the clearing FCM will never get the original order ticket from the executing firm. Therefore, the clearing firm will have no reliable source documents upon which to rely in identifying post allocation trades on customer confirmation statements. Indeed, once a customer has been advised that it is subject to Regulation 1.35(a-1)(5)'s requirements, the presumption will be that all orders are entered in that manner. This is consistent with how orders are entered for "discretionary" accounts. See NFA Compliance Rule 2-8(b) and CBOT Rule 423.02.

Lastly, with regard to two small technical items, NFA requests that the Commission clarify the phrase "and its principal, if any" in proposed Commission Regulation 1.35(a-1)(5)(ii). After discussions with Commission staff, it appears that the term "principal" in the proposed regulation refers to agency theory, which does not have the same definition as "principal" in NFA's Registration Rules.

Furthermore, NFA recommends that the Commission amend proposed Regulation 1.35 (a-1)(5)(vi)(A)'s requirement that each eligible order's ticket identify the account manager placing the order by name to allow for the identification of the account manager by code or other appropriate identifier.



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Conclusion

In conclusion, NFA again applauds the Commission for working with the futures industry in drafting repropoed amendments to Regulation 1.35. We feel that the Commission's reproposal represents significant progress toward the goal of streamlining the regulatory structure for those sophisticated parties engaging in financial transactions. In any case, no matter what final amendments the Commission adopts, NFA suggests that the Commission adopt this rule for a one-year pilot program and then reevaluate its usage with an eye toward expanding its application to other types of customers and any other adjustments deemed appropriate based upon experience. Actual experience with the rule could illustrate that it is appropriate for other types of accounts. As always, we look forward to working with the Commission on these issues and are hopeful that these comments assist the Commission in fine tuning its proposal to better achieve its stated goals.

Sincerely,

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

Daniel J. Roth
General Counsel

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