COMMODITY FUTURES TRADING COMMISSION
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DIVISION OF
TRADING AND MARKETS

95-63

July 17, 1995

Re: Allocations of "Bunched" Orders

Dear :

This letter responds to your letter dated April 25, 1995, in which you requested confirmation from the Division of Trading and Markets ("Division") that proposed use of "bunched" orders by a registered investment advisor ("Advisor"), as described, will not violate the Commodity Exchange Act ("Act") and Commodity Futures Trading Commission ("Commission") regulations thereunder. Based upon the representations made in the letter, we understand the facts to be as described below.

a registered futures commission merchant ("FCM"), has established accounts which represent retirement plans created for the benefit of partners and employees ("Plans").[1/] The Advisor has discretion over certain assets of the Plans and invests and trades the assets committed to its management through a variety of programs and strategies involving, among other instruments, equity and fixed income securities, currencies and money market instruments. In connection with these activities, the Advisor purchases and sells futures and options on futures on commodities, currencies, government securities, stock indexes and other instruments in a manner incidental to the trading of securities, for hedging and non-hedging purposes. The Advisor also invests and trades the assets of other accounts committed to its management. Although you state that the Advisor is not affiliated with , you also state that the chairman, chief executive officer and sole controlling shareholder of the Advisor was formerly a general

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1/ recognizes that because general partners and senior employees of have interests in the Plans, the accounts of the Plans are considered proprietary accounts of under Commission Regulation 1.3(y).

partner and is currently a limited partner of .[2]

The Advisor has proposed to include futures and futures option orders entered for the accounts of the Plans in bunched orders which include other accounts under its management.[3] All bunched futures and futures option orders would be entered using an identification number which represents the accounts included in the bunched order and the executed transactions would be allocated to the included accounts through the use of the average pricing systems operated by the Chicago Mercantile Exchange and the Chicago Board of Trade. As a result of this allocation method, the accounts of the Plans would receive the same average price received by the other accounts included in the bunched order. In the event that an order is not completely filled, you state that the Advisor will allocate partial fills on a pro-rata basis to assure fairness. would disclose to the customer accounts that all accounts included in the bunched order would receive allocations based on an average price and that partial fills would be allocated among accounts on a pro-rata basis. Further, customer accounts would be notified that in the event of a pro-rata allocation, the inclusion of the accounts of the Plans in the bunched order would result in customer accounts receiving fewer contracts than they would have had the accounts of the Plans not been included.

You note that the Commission, in a proposed amendment to its Regulation 1.35,[4] stated that "both the Commission and the courts have accepted the use of allocation formulas for properly documented bunched customer orders provided that the formulas result in fair allocations of the fills to the customers included in the bunched orders."[5] You state that because the orders described in your proposal would be allocated in accordance with exchange average pricing systems that would assure "fair allocations" to all accounts, the proposal is consistent with

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2/ You state that this individual is not currently involved in the operations or management of and that he has an interest of less than one percent in the overall assets of the Plans and of approximately one percent in the assets of the Plans allocated to his management.

3/ proposes to execute and clear the transactions on behalf of the Advisor, including the accounts of the Plans. currently provides brokerage and custodial services to certain other accounts ("customer accounts") managed by the Advisor.

4/ 58 Fed. Reg. 26170 (May 3, 1993).

5/ Id. at 26272.

existing law and should be permissible under the Act and Commission regulations.

You also note that the proposed amendment addressed the issue of including in a bunched order proprietary accounts of an advisor entering, or of an FCM executing, the bunched order along with customer accounts. Under the proposed amendment, such proprietary account orders could be bunched with customer account orders only if the proprietary accounts "receive the worst fills, both quantitatively and qualitatively" and are "allocated fills only if all customer orders are filled."[6/] Because the accounts of the Plans would be considered proprietary accounts of under both the definition of proprietary account in the proposed amendment and under Commission Regulation 1.3(y), they would be required to receive the "worst fill" if bunched with customer account orders and executed through . Thus, the proposed amendment could be applied to prohibit the Advisor from including accounts of the Plans in the bunched orders because the accounts of the Plans would not receive the "worst fill" under the average pricing systems and would be allocated fills even if all customer orders have not been completely filled.

You conclude, however, that the proposed bunching of customer and proprietary orders by the Advisor should be permissible. First, executions would be allocated "fairly and equitably" to customer accounts included in the bunched order. Accounts of the Plans would not receive the "worst fills", but would receive fills which are no better than those received by any other accounts included in the bunched order. The use of an average price system would assure that the accounts of the Plans would receive the same average price received by other accounts included in the orders.

Second, you state that "the Advisor's fiduciary obligations to the Plans under the Employee Retirement Income Security Act of 1974 would not permit the Advisor to allocate fills to the Plans 'only if all customer orders are filled.'" You do, however, agree that "the Advisor will allocate partial fills on a pro-rata basis to assure fairness." Thus, with regard to the quantity of the fills, the accounts of the Plans would be treated on a pro-rata basis with other accounts included in the orders.

Finally, you note that although the accounts are proprietary with respect to , the Advisor would make all trading decisions subject to its fiduciary obligations. Neither nor its other partners, employees or affiliates would exercise any discretion or control over such orders.

6/ Id.

Commission regulations include provisions relevant to customer orders. Specifically, Regulation 1.35(a-1)(1) requires that immediately upon receiving a customer's or option customer's order, an FCM prepare a written record of such order including, among other things, the account identification and order number. Regulation 1.35(a-1)(4) requires that each member of a contract market reporting the execution of a customer's order from the floor of a contract market make a written record of such order including, among other things, the account identification and order number.

Regulation 155.3 requires that FCMs insure, to the extent possible, that a customer order executable at or near the market price is transmitted to the floor before any like order for any proprietary or affiliated account.

The Commission's proposed amendments to Regulation 1.35 would codify an exception to the Regulation 1.35(a-1)(1) and (4) requirement to include the individual customer account identification on a written record at time of entry and report of execution. The exception would be applicable to a bunched order for which the person placing the order provided both a single identifier that identified all the customer accounts included in the order and a predetermined allocation formula for allocating the fills.

In addition, "some industry participants believe that it is not improper for proprietary orders to be bunched with customer orders as long as the proprietary account always receives the worst fill."[7/] The proposed amendment specifically allows the bunching of proprietary orders with customer orders under "worst fill" conditions.

Therefore, for purposes of account documentation requirements, the Division believes that in the specific circumstances you have described the individual account identification requirement of Regulation 1.35(a-1)(1) and (4) is satisfied by using an identification number for the bunched order that refers to each of the accounts included in the order.

Regulation 155.3, which requires that a customer order be transmitted to the floor before a like proprietary order, is designed to prevent an FCM from trading ahead of, and thus taking advantage of, a customer's order. Your proposal would result in a customer's order being transmitted to the floor at the same time as a like proprietary order, in that customer and proprietary account orders would be bunched for execution as a single order.

7/ Id.

The Commission's proposed amendment to Regulation 1.35 proposed to permit such bunching subject to a "worst fill" requirement with respect to a proprietary account order included in the bunched order. This was intended as an additional safeguard against the possibility of preferential allocation to the proprietary accounts. The overriding issue, however, is the fairness of the allocation formula. The use of an average pricing formula should result in allocations that are fair with respect to price allocation, or quality of fills. Also, pro-rata allocation of partial fills should result in allocations that are fair with respect to quantity of fills.

Subject to the facts and conditions stated above and based upon the representations in your letters of April 25 and June 12, 1995, the Division will not recommend an enforcement action under Section 4b of the Act or Commission Regulations 1.35 or 155.3 if the Advisor bunches the orders of the accounts of the Plans with other customer account orders for execution by, and clearing through, using an average pricing formula and pro-rata allocation of partial fills. All other provisions of the Act and Commission regulations will continue to apply, including sections 4b and 4o of the Act, 7 U.S.C. §§ 6b, 6o.

Please be advised that the Division's conclusion is based on its understanding of the facts and circumstances as represented. Any different, omitted or changed facts or conditions might require a different conclusion. Of course, this conclusion is also subject to any further regulatory action which the Commission may take in this area. Finally, you should note that the views expressed herein are solely those of the Division and are not binding on the Commission or any other division or office of the Commission.

Very truly yours,

Andrea M. Corcoran
Director