

CFTC Letter No. 99-26

July 7, 1999

No-Action

Division of Trading & Markets

Re: Commission Regulation 1.35(a-1)(5);, Inc.; Request for No-Action Position to Treat a Commodity Pool with Assets of Less than \$5,000,000 as an Eligible Customer for Purposes of Qualifying for Post-execution Order Allocation

Dear:

This is in response to your letter dated January 12, 1999, to the Division of Trading and Markets ("Division") of the Commodity Futures Trading Commission ("Commission") as supplemented by telephone conversations with Division staff. By your correspondence, you request a no-action position on behalf of __, a registered commodity trading advisor,¹ so that __ may treat the ("Employee Fund"), a commodity pool with assets of less than \$5,000,000, as an eligible customer for purposes of orders placed, executed, and allocated pursuant to Commission Regulation 1.35(a-1)(5).²

Based upon your representations, we understand the facts to be as follows. __ currently uses an electronic block order allocation system, which uses the average price method, for all allocations of trades. This allocation system calculates a weighted average price for all fills for a particular order, including fully filled orders, split and partial fills, and spreads. The system sorts all accounts into ascending order of dollar equity size and then allocates all contracts for the fill which has the price closest to the target price, starting with the smallest account and working through to the largest account. Contracts are allocated proportionally to each account based upon the relative account equity size of those accounts included in the total order. Any residual amount which results from rounding is calculated and applied to the accounts, starting with the largest and working through to the smallest account. You represent that this system is considered to be the most consistent and non-preferential method for allocating trades and produces a complete audit trail. In addition, compliance staff at the National Futures Association ("NFA") has confirmed that the allocation system complies with the NFA Interpretation related to trade allocation methodology.³

__ would like to use its allocation system to allocate orders for all of its managed accounts on a post-execution basis pursuant to Commission Regulation 1.35(a-1)(5), Orders

eligible for post-execution allocation, a recently adopted regulation.⁴ However, ___ is unable to apply the new methodology to all of its accounts because one of the commodity pools managed by ___ does not meet the definition of an "eligible customer" as described in Regulation 1.35(a-1)(5)(ii)(E). Specifically, the Employee Fund does not have total assets exceeding \$5,000,000, and thus is not an eligible customer for the purposes of qualifying for inclusion in a bunched order eligible for post-execution allocation. You represent that this account is the only account managed by ___ that is not eligible to participate in a post-execution allocation. By letter dated March 4, 1999, ___ represents that ___ currently manages 84 commodity pool accounts, including both pools and funds as those terms are commonly used.

The Employee Fund, as of December 1, 1998, had 44 participants and a net asset value of approximately \$1.897 million and is expected to continue to grow, both in number of participants and value. Of the 44 current participants, 40 are employees of ___ or its affiliates, two are former employees of ___ or its affiliates, and two are immediate family members of employees of ___. Nine of the participants qualify as accredited investors within the meaning of Securities and Exchange Commission Regulation D, Rule 501.⁵ The Employee Fund has a minimum investment requirement of \$5,000, and an investment cannot exceed 20% of the potential investor's previous year's gross income or 10% of his or her net worth. In order to be eligible to invest, subject to waiver or modification by the general partner in its discretion, an employee must have been employed for a minimum of one year by a company in the futures industry, have comparable experience in another financial services industry, or have been employed by or an affiliate for at least six months. The CPO of the Employee Fund is, an affiliate of ___, which also acts as the CPO of a pool with assets exceeding \$5,000,000 and which satisfies the definition of a "qualified eligible participant" in Regulation 4.7(a)(1)(ii)(A)(3).

___ believes that, because of the advantages of the post-execution allocation format, as well as to assure equitable treatment of all accounts, it is important to apply the new methodology to all of its accounts. Absent relief, ___ would be required to use two separate allocation systems, distinguished only by account size. These systems could, over time, lead to materially different performance results between pools with more than \$5 million in assets and pools with less than \$5 million in assets managed pursuant to the same trading program. Absent relief, only the Employee Fund, in which a significant number of employees who played a role in designing, developing, and/or implementing the electronic block order allocation system are invested, would not participate in the order allocation system that is applied to the other accounts. Use of different allocation methods could raise concerns about disparate treatment of accounts and complicate the account oversight obligations of CPOs, since they might need to assess the effects of timing differences and be concerned about possible apparent favoritism on behalf of the Employee Fund.

Pursuant to Regulation 1.35(a-1)(5), bunched orders for eligible customers identified in

1.35(a-1)(5)(ii) can be placed without specific account identification both at the time of order placement and at the time of report of execution. Orders placed in this manner can be allocated to the eligible customer accounts on a post-execution basis. In light of an overriding concern that allocations should be fairly made, and recognizing that the ability to allocate fills subsequent to execution potentially increased the opportunity for preferential allocation, the Commission determined to limit the customers for whom such orders could be placed. Thus, the criteria used to determine whether a customer is an eligible customer were designed to assure that the customers for whom such orders are placed are capable of understanding bunched order and post-execution allocation procedures and risks and are sufficiently sophisticated to monitor the results of post-trade allocations in their accounts. The Commission determined that, in order to meet that criteria, commodity pools would be required to have total assets exceeding \$5,000,000.⁶

The Commission also recognizes, however, that an asset requirement as an indication of customer sophistication is but one of several measures designed to encourage fairness in the allocation of fills. The Commission, for instance, has consistently encouraged the use of average price methodology for allocating fills. Regulation 1.35(a-1)(5) sets forth other requirements, including disclosure, certification, and recordkeeping, that are designed to assure fairness in allocations. In light of this concern for fairness, the Division understands the particular facts presented by with respect to the Employee Fund to be as follows:

1. ___ will employ its electronic block order allocation system for the allocation of trades executed pursuant to Regulation 1.35(a-1)(5) and allocated on a post-execution basis. This allocation system uses the average price method for all allocations.
2. The CPO of the Employee Fund, also acts as the CPO of a fund with assets that meet the \$5,000,000 requirement and thus satisfies the definition of a "qualified eligible participant" in Regulation 4.7(a)(1)(ii)(A)(3).
3. Participants in the Employee Fund are the current and former employees of ___ or its affiliates or immediate family members of employees of ___.

Subject to the facts and conditions stated above and based upon your representations, the Division will not recommend that the Commission commence any enforcement action against ___ based solely upon the inclusion of the Employee Fund in a bunched order placed pursuant to Regulation 1.35(a-1)(5) and allocated on a post-execution basis. The position taken in this letter does not excuse ___ from compliance with any other requirements contained in the Act or Commission regulations promulgated thereunder, and in particular, the remaining provisions of Regulation 1.35(a-1)(5) and all applicable antifraud provisions of the Act and Commission regulations. Further, this letter, and the no-action position taken herein, is based upon the representations that have been made to

us and any different, changed, or omitted material facts or circumstances might render this letter void. You must notify us immediately in the event that the activities of ___ or the Employee Fund change in any material way from those as represented to us.

If you have any questions concerning this correspondence, please contact Duane C. Andresen, an attorney on my staff, at (202) 418-5490.

Very truly yours,

I. Michael Greenberger

Director

¹ ___ is also a registered commodity pool operator ("CPO").

² Commission regulations referred to herein can be found at 17 C.F.R. Ch. I (1998).

³ NFA Interpretive Notice to NFA Compliance Rule 2-10 Relating to the Allocation of Block Orders for Multiple Accounts. This Notice is published as paragraph III in Appendix C to Part One of the Commission's Regulations.

⁴ Commission Regulation 1.35(a-1)(5) became effective October 26, 1998. To date, the Commission has not issued any exemptive, no-action, or interpretative letters pursuant to this regulation.

⁵ 17 C.F.R. §230.501(a) (1998).

⁶ This \$5,000,000 asset requirement was based, in large part, upon prior Commission determination that a commodity pool with assets exceeding \$5,000,000 qualifies as an "eligible participant" within the meaning of Regulation 36.1(c)(2) and as an "eligible swap participant" within the meaning of regulation 35.1(b)(2).