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COMMODITY FUTURES TRADING COMMISSION

MANAGED FUNDS ASSOCIATION

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COMMODITY FUTURES TRADING COMMISSION RECEIVED FOR PUBLIC RECORD

Jean A. Webb
Office of the Secretariat
Commodity Futures Trading Commission
Three Lafayette Centre
1155 21st Street, N.W.
Washington, D.C. 20581

Re: Reproposed Amendments to Regulation 1.35 Relating to Account Identification for Eligible Bunched Orders, 63 Federal Register 695 (January 7, 1998)

Dear Ms. Webb:

The Managed Funds Association respectfully submits this comment letter[1] to the Commodity Futures Trading Commission (the "CFTC") in response to its request for comments on its release published January 7, 1998 in the Federal Register at 63 Fed. Reg. 695 (the "Release") in which the CFTC reproposed amendments to its Rule 1.35(a-1) regarding account identification of eligible bunched orders.

The Managed Funds Association (MFA), a national trade association of more than 690 members, represents the managed futures, hedge funds, and fund of funds industry. MFA membership is composed primarily of financial and commodity trading advisors, pool operators and trading managers who are responsible for the discretionary management of the vast majority of funds that currently invest in futures, as well as significant amounts invested in hedge funds and other financial and commodity-linked investments. MFA membership also includes the sponsors, investment managers and brokers for substantially all of the financial and commodity pools marketed on either a public or private basis in the United States. Accordingly, MFA and its members are vitally interested in the CFTC's proposed rule revisions.

MFA appreciates the opportunity to comment on the CFTC's proposed rulemaking. MFA especially commends the CFTC for its initiative in reconsidering a significant but complex rulemaking and its efforts to obtain input from the industry, market participants, end users and self regulatory organizations in multiple forums. MFA is encouraged not only by the CFTC's initial responsiveness, but also by its willingness to take a "fresh look" at the proposed amendments. The passage of nearly five years and significant evolution in business practices

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[1] This letter has principally been prepared by MFA's Trading and Markets Committee and its Government Relations Subcommittee on Restrictions on Trading Capacity.

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that have occurred since the originally proposed rulemaking have enabled commentators to evaluate further the proposed rulemaking and to refine their comments accordingly. In light of this new input, MFA encourages the CFTC to modify the final amendments to give the proposed rule maximum utility in a manner consistent with its regulatory objectives. MFA is cognizant and supportive of the changes the CFTC has made from the originally proposed rules including amendments that would expand: (i) the class of eligible customers to include most entities defined as eligible participants under Part 36, (ii) the permissible proprietary interest in an eligible order, and (iii) the mixed portfolios that are eligible to participate.[2] MFA believes maximum utility of the amended rule is dependent upon eliminating, rather than merely narrowing these restrictions. Nonetheless MFA believes that the rule's procedures will not be fully utilized and the CFTC's regulatory objective frustrated if the rule is not simplified further. MFA encourages the CFTC to focus on the broad and important objectives of the proposed rule and to eliminate the requirements that do not significantly contribute to customer protection.

In this rulemaking, the CFTC has the opportunity to achieve two significant objectives: to make the futures markets more competitive by removing a significant regulatory barrier to access to the futures markets; second, the CFTC has the opportunity to bolster customer protection by instituting a uniform requirement on account managers for fair, non-preferential and verifiable allocation methodologies - a standard generally superior to existing standards required by other regulators or currently by the CFTC. These objectives can best be achieved by adopting a structural framework with sufficient flexibility yet strong customer protections from which exchanges will be able to craft rules with practical utility and requirements as necessary and appropriate for the markets in question.

The CFTC has proposed four requirements under the rule to strengthen customer protection: a fairness, non-preferential allocation standard, the account manager certification, customer consent and recordkeeping requirements. Each is discussed below.

Adoption of Customer Protections.

A. Adoption of Fairness Standard for Order Allocation Methodologies.

MFA strongly endorses the CFTC's proposal to strengthen customer protections but believes that the framework should be made accessible to all orders of qualified account managers. The

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[2] The CFTC also appropriately proposed to expand the definition of account managers eligible to utilize the new rule. MFA believes the definition should be further expanded to include (i) foreign advisors, whether registered with, or exempt from, CFTC registration or who are regulated in their home jurisdiction, who provide advice to non-U.S. persons but nonetheless trade on U.S. markets, and (ii) investment advisers exempt from SEC registration under §203(b)(3). The CFTC's proposed compliance requirements should effectively deter misallocations by qualifying account managers.

additional safeguards that would be established by the proposed rule will ensure fairness, non-preferential treatment and verifiability of order allocation. As such, the rule should be the model for order allocation for the accounts of all customers and account managers. Rather than proposing a rule restricted to only the most sophisticated customers (who are capable of protecting their own interests), the CFTC should be seeking to make application of the rule as broad as possible so that the small customer will be protected by the standards adopted. If an allocation methodology is fundamentally fair, non-preferential and verifiable, it will be fair for all orders allocated by that methodology; whether big, small, proprietary, sophisticated or unsophisticated. By restricting accounts that are able to participate in such an order allocation methodology, the rule inadvertently creates not only an audit issue and opportunity for those account managers who might use such a rule to manipulate allocations but also creates a problematic and extremely cumbersome process for the vast majority of account managers who are reputable and attempt to comply with the CFTC's requirements, as discussed below.

B. Account Manager Certifications.

In the reproposed rule, the CFTC has proposed that the account manager provide a certification in writing that the account manager is aware of the provisions of the rule and is, and will remain, in compliance with its requirement. MFA supports the certification requirement and believes the blanket certification from the account manager best effectuates the purpose of the rule. MFA believes it is appropriate, as currently proposed by the CFTC, that this certification be all inclusive and that the certification not be lengthy or specify the manner in which the account manager will ensure compliance with the rule.

The CFTC has required that such certification be made to each futures commission merchant executing "and/or" allocating any part of the order. MFA believes the "and/or" in the rule is unclear as to whom the certification need be made. MFA believes that such certification is most effectively made either with the clearing futures commission merchant who is required to deal with the issue of order allocation or with the National Futures Association (the "NFA"). The CFTC has approved the NFA's Interpretative Notice relating to the allocation of block orders for multiple accounts that it intends to append to the final rule. This notice permits filing of a similar certification with the NFA. Considering CFTC registrants' familiarity in filing or obtaining information from NFA in connection with their other regulatory obligations, registrants should be permitted the option of filing such certification with the NFA. For the typical account manager whose orders are cleared through numerous futures commission merchants the alternative of filing a single certification with the NFA and maintaining an accurate certification in one location has added efficiencies and minimizes the regulatory burden without detracting from the regulatory protection provided by such certification.

C. Customer Consent.

MFA believes that the CFTC could most effectively achieve its customer protection objectives by expanding the requirements of its proposed customer consent to include a disclosure

obligation. The CFTC should require the account manager to disclose to the customer generally the nature of its allocation methodology and the fairness standard required of such methodology, the ability of the customer to request confirmation from the account manager of the operation of its methodology and the extent to which the proprietary account manager has accounts participating in the block order. As discussed more specifically below, MFA believes the best result from a regulatory, compliance and customer perspective, would be to include all accounts in which the account manager has any proprietary interest in the block order so that such orders will be allocated in accordance with the fairness standard and subject to the other customer protections, including an ability to verify application of the allocation methodology, as proposed in the Rule. By requiring this information to be included in the disclosure to the customer, the CFTC ensures that the customer is making an informed consent to participation in the block order and fair allocation procedures.

With respect to signed acknowledgments evidencing customer consent, MFA believes that the consent provision of the rule is the *only* provision in the rule in which a distinction should be made between sophisticated and unsophisticated customers. Similar to the CFTC's ongoing efforts to develop a two tiered regulatory structure which recognizes the necessity for differences in regulatory requirements for sophisticated and unsophisticated customers, MFA believes the proposed rule should require written acknowledgments only from unsophisticated customers whose accounts will participate in the block order.[3]

"Sophisticated customers" for this purpose should be the identical definition to that used in either §4.7 (b)(1)(ii)(B), the rule exempting qualified eligible clients from specific disclosure requirements, or that in Part 35. There are significant issues, regulatory burdens, complexity and confusion in opening and maintaining customer accounts, especially for account managers seeking to obtain fair and equal treatment across all accounts managed, due to the multiplicity of definitions of sophisticated customer to which the account manager is subject. The regulatory justification for such multiple definitions, to the extent there is any, does not outweigh the confusion and chilling effect they have on market participants and their use of available exemptions. Either a participant is sophisticated enough to be exempt from many of the CFTC's

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[3] The CFTC appropriately has exempted accounts of sophisticated customers from many of the specific customer protection requirements under the Act, including written acknowledgments of risk disclosure generally, as most recently evidenced by the amendments to Regulation 1.55. Considering the many other customer protection requirements that would be adopted in the reproposed rule, none of which arguably should be necessary if the participating accounts were solely those of sophisticated clients, the written acknowledgment requirement is burdensome and outweighed by the additional compliance burden that would be required. Sophisticated customers generally are sufficiently equipped by virtue of their sophistication, the resources available to them or the influence they enjoy by virtue of the size of their investment with the account manager to obtain whatever information they believe appropriate to satisfy themselves as to the manner in which their account is handled, including order allocations.

regulations or not. Certainly natural persons with total assets in excess of $10,000,000 are just as adequately equipped to protect themselves as are entities with equal or half that amount of total assets. Certainly, natural persons able to protect themselves when engaging in swap or exempt contract market transactions are more than able to protect themselves in obtaining information necessary to assure themselves of the allocation of their accounts, especially when account managers are subject to the many other multiple customer protections in the proposed rule. There can be no regulatory objective achieved by the continuing multiplication of the definition of 'sophisticated customer' under the CFTC's regulations. MFA urges the CFTC not to create yet another definition for this term.

D. Recordkeeping Requirements.

MFA commends the CFTC for streamlining the recordkeeping requirements as originally proposed, but nonetheless believes that some additional refinements are necessary. Orders entered pursuant to the relief contained in this rule may be sufficiently tracked and audited without literally carrying the label as such throughout the execution, clearing and confirmation procedures. The cost of requiring compliance with this requirement is large without achieving any identifiable separate regulatory objective. The account manager should be required to identify the orders as such at the time of entry and on its trade blotter and allocation sheets. The rule should permit use of an account identifier with respect to the group of accounts to be allocated in the block order and if so, the group identifier would be sufficient to track the order through execution, clearing and confirmation for audit purposes. The group identifier should appear on the office or floor order ticket, as applicable. Account managers and FCMs, if applicable, allocating the order should be required to do so no later than the deadline for submission of trade data established by the exchange or market on which the trade is made. MFA agrees the foregoing are simply recordkeeping requirements essential to the maintenance of an audit trail and review of the order for compliance with the other requirements of the rule.

MFA agrees that each account manager should retain, and make available records reflecting order placement, allocation in participating accounts, the basis for the allocation and any other record essential to determining whether any particular allocation has been made in compliance with the account manager's stated allocation strategy. However, MFA objects to the requirement that an account manager be required to maintain records demonstrating the relationship between the futures and other transactions and the nature of the intermarket strategy for two reasons. First, MFA believes the relief provided by this rule should be available whether an account manager has an intermarket trading strategy or not. Second, and more importantly, the requirement that an account manager maintain, for purposes of this rule, records demonstrating the account manager's trading strategy may cause unnecessary disclosure of proprietary trading strategies and procedures, which are not necessary to the determination of compliance with the allocation methodology. Rather, MFA believes the requirement of this rule should be narrowed to require retention only of information essential to the determination of the appropriateness of the allocations made, which an account manager should be required to make available to the CFTC, NFA or Department of Justice. In addition, MFA believes the rule should be clarified so

as not to require disclosure of comparative account information of other customers to any particular client, but rather disclosure of summary information for the accounts for which such orders are made, upon request of a client.

Elimination of Eligibility Restrictions.

As indicated above, MFA believes that the efficacy of the rule is dependent upon elimination of many of the CFTC's proposed eligibility restrictions including those on accounts in which only Commodity Exchange Act-regulated instruments are traded, accounts in which the account manager (or allocating FCM) has a proprietary interest, and eligible customers. If the requirements of the rule are too complex, burdensome and cause an account manager to divide up accounts, devise and process orders for accounts traded under the same trading strategy pursuant to more than one order allocation methodology, it will be very difficult to utilize the rule. This, of course, is not the desired regulatory objective of the CFTC or the industry. Accordingly, the CFTC should be confident that the restrictions it seeks to impose are essential to achieving its regulatory objective. MFA believes the referenced eligibility restrictions do not meet this test.

Considering the CFTC's four strong customer protection requirements drafted in the proposed rule and referenced above, MFA believes these requirements alone provide the necessary structural framework for implementation of this rule. The CFTC's proposed customer protection requirements will ensure that accounts which an eligible account manager places into the block order for allocation will receive allocations pursuant to a fair, non-preferential allocation methodology from which actual allocations can be verified. The existing applicable anti-fraud requirements will be strengthened by an affirmative requirement that the allocations be fair and non-preferential. Account managers will be required to follow certain stringent procedures, including certifications, disclosure and recordkeeping requirements to explain and document the operation of their allocation methodology.

Because of the audit trail and orderly processing for bunched orders required by the strengthened customer protections in the proposed rule, the CFTC should seek to include, rather than exclude, as many, and preferably all, accounts of account managers utilizing the block order rule. Accordingly, all the eligibility restrictions discussed below should be eliminated. In addition, MFA believes the following specific reasons further justify elimination of these restrictions.

> *A. Exclusion of Account Managers Who Trade Only Markets Solely Regulated under the Commodity Exchange Act.*

The CFTC's proposal to exclude from the proposed relief account managers whose portfolios consist solely of CFTC regulated instruments raises more issues than it answers with no clear regulatory objective. MFA believes that the CFTC should feel most comfortable in making this relief available to account managers exclusively subject to the CFTC's regulatory structure. In

addition, such an artificial division causes unnecessary ambiguity as to eligibility for account managers whose trading is 'linked' less directly to other markets such as those who solely use futures for overlay, asset allocation or hedge strategies without managing the underlying assets that might be traded in a non-CFTC regulated market. It is unclear why these account managers would be required to demonstrate a 'need' to utilize a rule that provides greater flexibility in trading and benefits customers by permitting 'more fair' allocations of orders while strengthening customer protections for such orders. Moreover, 'futures only' account managers also have need for the rule's relief. There are a number of situations in which managers should not be excluded from claiming the proposed relief solely because they trade only CFTC regulated instruments: (a) Account managers who seek to provide average pricing on all transactions to their clients, and whose trading strategies are such that trading decisions made intraday are dependent upon prior trades or allocations which may not be available at the time the subsequent order needs to be entered: (b) CTAs who have a large number of accounts at multiple FCMs whose allocation methodologies are dependent upon daily equities and positions (similar to the securities allocation examples noted by the Chicago Mercantile Exchange in the earlier rulemaking); (c) CTAs whose strategies involve trading instruments on more than one exchange in an 'order' or who receive a partial fill of an order on one exchange and must then enter an order in a related instrument or multiple contracts of a smaller sized contract to round out their order; and (d) CTAs who seek to enter large orders in the futures markets without impacting price during times of less liquid markets or to maintain anonymity for larger orders in smaller markets by feeding the orders into the market in an orderly fashion during the course of a day. The CFTC should extend this order allocation flexibility to the markets that it regulates to make those markets competitive with other markets and to encourage account managers to continue trading and providing liquidity to those markets, rather than forcing them to other markets where that flexibility exists.

B. Exclusion of Accounts in which the CTA has a Significant Proprietary Interest.

Consistent with the philosophy of NFA Compliance Rule 2-10 which permits both customer and proprietary accounts to be entered as a block order, the CFTC's proposed amendments should permit *any* qualifying account, regardless of the amount of proprietary interest of the account manager or 'allocating' FCM (10% or 100%) to be included in the block allocation. To require a manager to trade a proprietary account outside the block order greatly diminishes the effectiveness of the audit process and creates complexity and opportunities for misallocations in monitoring, auditing and implementing the separate allocation procedures. In addition, a manager's interest in an account may fluctuate in size over time and the consequences of an account's being part of the block orders and so eligible to use this rule at times, and at other times be outside the block, are not only cumbersome and potentially create liability for the account manager, but in fact may provide an opportunity for dishonest managers to effectuate fraudulent allocations by changing their proprietary investment or otherwise changing the group of accounts that trade within rather than outside the block allocation.

The restriction on proprietary investment in the account also ignores the overwhelming history and customary practice of commodity trading advisors in the managed funds industry. Historically, the more efficient fund vehicles which provide limited liability and diversification for small investors, have only been made available by sponsorship of account managers or FCMs willing to advance the costs of organizing such vehicles. In addition, many of the most talented account managers would not trade client funds if they were unable to invest their own proprietary capital on terms similarly to the client funds they trade. Account managers frequently invest all their proprietary capital in fund vehicles in which such account managers as general partners bear potential liability for the fund's obligations and their clients invest as limited partners to simplify compliance issues and to achieve trading efficiencies. Fund investors have not only favored having account managers trading side by side with the investor, but most institutional clients require account managers to have a significant proprietary investment, either in the fund or in a managed account to align the account manager's and investors' interests. To exclude these accounts from the relief would effectively preclude most managed fund account managers from utilizing the rule and would significantly disadvantage existing investor entities in which account managers have a significant proprietary interest. Excluding "Business Affiliates" also arguably excludes the typical pool structure in which the account manager is general partner, regardless of the percentage ownership interest.

It also is unclear what is meant by the FCM "allocating the order". If that does not include the futures commission merchant who merely matches fills according to the allocation instructions of the account manager, predesignated or otherwise, the restriction is less troublesome, although the efficacy of its regulatory purpose is questionable.

Finally, for the same reasons as stated above, the exclusion of accounts in which a spouse, parent, sibling or child of any of the above (FCM, CTA, etc.) has an interest is unnecessarily restrictive and frustrates the utility of the proposed rule change. Where the allocation methodology is fair and non-preferential as to all orders in the block, it is not relevant whether one or more of those accounts is owned by a person or entity related to, or invested in by, the account manager or futures commission merchant.

C. Limitations on Definition of "Eligible Customers".

With some extremely notable exceptions such as the exclusion of natural persons, proprietorships and self-directed employee benefit plans, the proposed rule permits participation only by accounts owned by entities which generally qualify under the CFTC's Part 35 exemption for eligible swaps participants. The continuing proliferation of definitions of sophisticated customers, eligible participants or what ever the new rule might propose will make opening and maintaining compliance on accounts more difficult. The industry now has more than five different definitions with which it must deal in any particular offering or product geared to highly sophisticated and high net worth investors. Not only are the definitions different from each other, but the term for the participant is also different. The criteria for qualified eligible participant (i.e. a 'sophisticated client') should be those adopted in Part 35 on Reg. 4.7 without

change. In addition, a long term goal of the CFTC should be to rationalize those various definitions. The sophisticated customer meeting one of these definitions, including an individual with total assets of ten million, is also sufficiently sophisticated to consent to end of day order allocation and financially capable of protecting his or her own interests. Continual multiplication of these definitions merely creates confusion in the marketplace and greatly increases the burden and cost of compliance without any redeeming benefits.

Conclusion.

MFA again commends the CFTC for its efforts to provide necessary flexibility to its rules while maintaining appropriate customer protections. With respect to the reproposed rule amendments, MFA believes the CFTC's regulatory objectives will be significantly strengthened by simplifying the requirements of the rule and eliminating unnecessary restrictions. MFA believes the four customer protection requirements proposed by the CFTC, bolstered by MFA's recommendation to add certain disclosure to the customer consent, without more, would make the CFTC's final rule effective and usable and provide an appropriate framework within which exchanges could develop rules appropriate to their markets while strengthening the CFTC's current requirements related to order allocation. As such, MFA believes that reproposed Section 1.35 (a-1) (5), subparagraphs (i) and (iii) should be eliminated in their entirety with slight adjustments made to the remaining sections of the rule consistent with our recommendations herein.

MFA appreciates the opportunity to contribute to the rulemaking process and would be happy to respond to any additional questions or provide information to the CFTC as it deems appropriate.

Sincerely yours,

John G. Gaine
President