98-1
(16)

COMMODITY FUTURES TRADING COMM.

Goldman, Sachs & Co. | 85 Broad Street | New York, New York 10004
Tel: 212-902-1212

Bonnie S. Litt
Vice President
Associate General Counsel

MAR 23 2 11 PM '98

Goldman Sachs

COMMENT

March 23, 1998

MAR 26 9 25 PM '98
COMMODITY FUTURES TRADING COMMISSION
RECEIVED FOR PUBLIC RECORD

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

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

Dear Ms. Webb:

On behalf of Goldman, Sachs & Co. ("Goldman Sachs"), we are pleased to comment on the Commission's reproposed rules regarding account identification with respect to eligible bunched orders, 63 Fed. Reg. 695 (January 7, 1998) (the "Reproposed Rules"), which modify the Commission's proposed rules on the same issue, 58 Fed. Reg. 26270 (May 3, 1993) (the "Proposed Rules"). Goldman Sachs believes that the Reproposed Rules will facilitate the use of futures and options for hedging and other purposes by broadening the ability of account managers to enter bunched orders. However, we believe that expansion of the relief that would be available under the Reproposed Rules is necessary in order to achieve the Commission's objectives and that such expansion can be effected without compromising customer protection.

Goldman Sachs is registered with the Commission as a futures commission merchant ("FCM"), commodity pool operator and commodity trading advisor, and with the

MAR. 23. 1998 12:40PM GOLDMAN SACHS & CO. NO. 2945 P. 2

Securities and Exchange Commission as a broker-dealer and an investment adviser. In addition, Goldman Sachs or its affiliates are members of all major securities and futures exchanges worldwide and act as dealers and market makers in a wide range of financial instruments. Among other things, Goldman Sachs is actively engaged in the execution and clearance of transactions in the full range of financial and commodity futures, options on such futures and other derivative products.

As part of its FCM business, Goldman Sachs regularly executes and clears transactions in futures and options on futures on behalf of investment advisers, commodity trading advisors and major financial institutions that enter into such transactions for multiple accounts under their management. These entities have for many years expressed to Goldman Sachs their interest in using the futures markets to a greater extent to implement their trading strategies, both through transactions effected exclusively in the futures market as well as hedging or other types of transactions involving futures transactions and related transactions in other markets. Based on our discussions with these entities and others, Goldman Sachs has concluded that the ability of an FCM to accept bunched orders and allocation instructions from account managers will enhance the ability of such account managers to obtain better executions for their clients, manage accounts more efficiently and increase liquidity in the markets, without any adverse effects on customer protection.

We therefore supported the Proposed Rules issued in 1993 although, as set forth in our comment letter on the Proposed Rules, we believed that they were unnecessarily restrictive in a number of respects and we therefore advocated certain modifications.* We recognize that the Commission, in the Reproposed Rules, has addressed many of the concerns raised by Goldman Sachs and other industry participants in connection with the Proposed Rules and we commend the Commission for doing so. We believe that the Reproposed Rules represent a substantial improvement over the Proposed Rules and that they will allow for significant progress toward the goals outlined above.

---

* Letter of Goldman, Sachs & Co. to Jean A. Webb, dated June 10, 1993.

MAR. 23. 1998 12:40PM GOLDMAN SACHS & CO. NO. 2945 P. 3

We also believe, however, that there are several areas in which the Reproposed Rules should be modified further. In particular, and as set forth more fully below, Goldman Sachs recommends that the Commission (1) include certain categories of natural persons among the list of eligible customers, (2) include futures-only orders within the category of eligible orders, (3) include foreign advisors within the category of eligible participants and (4) eliminate the restrictions on inclusion of proprietary accounts in bunched orders. Through the adoption of the Reproposed Rules with these modifications, we believe that the Commission will have made substantial progress in addressing the concerns of institutional participants, which will facilitate greater institutional use of the futures markets and enhance liquidity in such markets to the benefit of all market participants.

1. Eligible Customers

In our view, the Commission's exclusion of natural persons from the categories of eligible customers under the Reproposed Rules will serve only to deny these customers – many of which are highly sophisticated and experienced – the benefits of bunched orders, thereby subjecting them to less efficient and potentially less favorable executions. Account managers will be required under the Reproposed Rules to use fair and impartial allocation systems and will be subject to certification and recordkeeping procedures, which will adequately address any customer protection concerns the Commission may have. In view of these protections, a blanket exclusion of all individuals is clearly unwarranted.

This restriction will also create administrative and operational difficulties for account managers, by requiring them to separate out the orders of individuals and execute them apart from the bunched orders used for other clients. This in turn will limit the availability of account managers willing to accept the accounts of individuals. The result of the Commission's proposal, therefore, will be to single out individuals for inferior treatment, impose greater costs and burdens on the handling of their accounts, subject them to less efficient and less favorable executions and create a bifurcated and inequitable system of customer accounts. This will operate to the detriment not only of the individuals affected, but also the markets as a whole.

MAR. 23. 1998 12:40PM GOLDMAN SACHS & CO. NO. 2945 P. 4

This result is particularly unwarranted in view of the fact that many individuals are as capable of understanding bunched order procedures and risks, and providing their knowing consent to such procedures, as corporate or institutional customers. In this regard, Commission Rule 4.7 recognizes that natural persons encompassed within the definition of a "Qualified Eligible Participant" ("QEP") are capable of evaluating the merits and risks of an investment in a commodity pool without receiving all of the disclosures ordinarily required of commodity pool operators under Commission rules.*

As the Commission stated in connection with its proposal of Rule 4.7, the inclusion of certain types of natural persons, among others, within the definition of a QEP reflects the fact that such persons "have an investment portfolio of a size sufficient to indicate that the participant has substantial investment experience and thus a high degree of sophistication with regard to investments as well as financial resources to withstand the risk of their investments." (57 Fed. Reg. 3148 at 3151). In our view, a person sufficiently sophisticated to evaluate an investment in a commodity pool without the disclosures otherwise provided to commodity pool participants is clearly capable of understanding and giving knowing consent to the inclusion of his/her orders in bunched orders entered by an account manager. For this reason, we recommend that the Commission modify the Reproposed Rules to include as eligible customers those individuals that qualify as QEPs under Rule 4.7.

Alternatively, if the Commission concludes that the Rule 4.7 standards are insufficient for purposes of the Reproposed Rules, we recommend that those natural persons included within the definition of "eligible participants" under Part 36 of the Commission's rules be treated as eligible customers. The Commission, as noted in the release announcing the Reproposed Rules (63 Fed. Reg. 695 (Jan. 7, 1998) (the "Release"), has based the eligible customer

---

* Rule 4.7, in relevant part, defines a QEP to include any natural person that is an "accredited investor" under Securities and Exchange Commission regulation D and that owns securities and other investments with a value of at least $2 million or has had on deposit with an FCM at least $200,000 in initial margin and option premiums.

MAR. 23. 1998 12:41PM GOLDMAN SACHS & CO. NO. 2945 P. 5

category on the Part 36 rules and we can see no reason to deviate from such rules in this respect. Indeed, because the natural persons that qualify as eligible participants must have at least $10 million in assets, they effectively constitute and generally operate as insitutions and should be treated as such.

2. <u>Eligible Orders</u>

We believe that all futures market orders should be eligible for the relief afforded under the Reproposed Rules, regardless of whether they are executed in connection with the management of a portfolio that includes other types of financial instruments. In this respect as well, the limitations imposed and the procedures required under the Reproposed Rules are adequate to protect against abusive practices. The exclusion of futures-only orders, therefore, creates additional impediments to the realization of the Commission's objectives without enhancing customer protection.

Account managers executing futures-only orders have the same need to respond rapidly to movements in the market that arises in the case of managers using futures as part of a broader portfolio management strategy. In addition, account managers are generally subject to significant operational and systemic constraints on their ability to provide allocations in advance of the execution of orders regardless of whether they relate to other transactions or positions. For example, a trading model might indicate that a particular transaction should be executed, and determine the aggregate number of contracts to be purchased and sold, but might not identify the specific allocation of this aggregate number among the accounts under management until shortly after it generates the trading signal. However, in order to avoid missing market opportunities, the account manager will likely wish to execute the order prior to the generation of the allocation instructions.

We also note that the trading models and systems used by many account managers are complex and may involve numerous adjustments throughout the course of a single trading day. Moreover, specific accounts traded by a manager might be subject to unique constraints that are not applicable to other accounts under its management. As a

result, it is often necessary for an account manager, particularly in fast moving markets, to be able to execute orders instantly and perform the allocation process subsequent to the completion of the transaction.* In such instances, customers will clearly be forced to forego the benefits of market opportunities, and will therefore be significantly disadvantaged, if the account manager is prohibited from using a bunched order to execute the indicated transactions.

In the Release, the Commission stated that the relief afforded under the Reproposed Rules is not necessary with respect to futures-only orders due to the availability of average pricing mechanisms on the futures exchanges. Average pricing, however, deals only with the price at which a customer's or group of customers' order is executed and does not address in any way the portion of each order that is allocated to particular accounts. Accordingly, even with an average pricing system in place, it remains necessary to utilize an allocation scheme and account managers trading exclusively in the futures markets — as well as their clients — will be unfairly disadvantaged by their inability to operate under the Reproposed Rules.

3. <u>Foreign Advisors</u>

Goldman Sachs also recommends that the categories of eligible participants covered by the Reproposed Rules be expanded to include foreign advisors. Given the international nature of the futures markets, and the

---

* We recognize that the Commission and the National Futures Association ("NFA") have stated that an account manager may pre-file standing allocation instructions with its FCM, which obviates the need to provide such instructions at the time an order is entered. 62 Fed. Reg. 25,470 (May 9, 1997). However, this approach does not adequately address those situations in which, because of interim adjustments made to accounts under its management or variations among accounts, an account manager cannot determine in advance the allocation scheme to be used in all instances. In addition, in our experience, many account managers are unwilling to provide their allocation schemes, which they consider to be proprietary, to their FCMs.

MAR. 23. 1998 12:41PM GOLDMAN SACHS & CO. NO. 2945 P. 7

extensive participation of foreign advisors and their clients in U.S. futures markets, the exclusion of foreign advisors will bifurcate the market, place foreign advisors and their clients at a competitive disadvantage and inhibit the effectiveness of the Reproposed Rules. These results are unwarranted and unnecessary. In our view, the benefits afforded through the Reproposed Rules should be equally available to clients of foreign advisors.

First, advisors operating pursuant to a Rule 30.10 exemption should unquestionably be eligible for the same treatment as U.S. registered commodity trading advisors or investment advisers. The Commission, by granting Rule 30.10 exemptions to professionals in such jurisdictions, has determined that the local regulatory schemes provide levels of customer protection that are comparable to those provided under the Commodity Exchange Act ("CEA") and Commission rules. Moreover, entities operating under such exemptions have consented to CFTC jurisdiction and service of process. For these reasons, we believe that the Commission should, at a minimum, include within the category of eligible participants those non-U.S. advisors operating pursuant to Rule 30.10 exemptions.

Second, those advisors located in countries that have received Rule 30.10 exemptions should be included within the scope of the Reproposed Rules regardless of whether such advisors themselves are operating pursuant to such an exemption. Advisors in this category also operate under regulatory schemes that the Commission has found to be comparable to U.S. regulation and their activities are subject to adequate supervision by local regulators. Moreover, because such advisors are not exempt from commodity trading advisor registration, they must limit their clients to non-U.S. persons. Consequently, the customer protection policies of the CEA and Commission regulations are not direclty implicated and the Commission should be more comfortable relying on local regulatory regimes.

Even if an advisor is not located in a jurisdiction that has received a Rule 30.10 exemption, we believe it should be permitted to operate under the Reproposed Rules. In such instances, the principal policy considerations underlying the Reproposed Rules — the protection of U.S. persons utilizing the futures markets — are not implicated and regulation of the advisor's practices

should be left to the advisor's local regulators, even if the advisor is not operating pursuant to a "comparable" regulatory scheme. Such advisors will in any event remain subject to the Reproposed Rules and will be required to utilize fair and equitable allocation procedures and provide the required certifications to their FCMs, which will provide ample protections to their non-U.S. clients.

4. Proprietary Interests

We also recommend that the Commission eliminate the restrictions on the level of proprietary ownership that an account manager may maintain in accounts included in bunched orders. The benefits provided by the use of bunched orders – larger orders and increased efficiency of execution – can best be realized by larger orders. Limiting proprietary interests of account managers to 10% of any account will unnecessarily restrict the size of orders included in bunched orders, thereby undermining the full realization of the Commission's objectives. Moreover, allowing account managers to include in bunched orders proprietary accounts in which they have more than a 10% interest will increase the account managers' incentives to obtain better executions. For these reasons, many institutional customers prefer their account managers to trade their own funds along with such customers' funds.

In addition, applying a rigid percentage test in order to determine whether an account is eligible to be included in a bunched order will be administratively burdensome at best and infeasible at worst. For example, if an account manager acting as a commodity pool operator maintains a proprietary interest in a pool of less than 10%, thereby allowing it to include orders for the pool in bunched orders, it is possible that, as a result of redemptions by other investors, the account manager's interest will increase to greater than 10%. It would be arbitrary and burdensome to require the account manager to monitor its interest in the pool continuously and to exclude orders for the pool from some bunched orders based on its proprietary interest at that time. Such a result would also be detrimental and inequitable to the investors in the pool.

Further, we do not believe that removing the limit on proprietary interests will have any adverse effect on customer protection. Account managers will be required in any event to use fair and equitable allocation schemes and

will be subject to fiduciary and other duties to their clients, regardless of the level of the proprietary interests they may have in accounts included in bunched orders. Indeed, preferential allocations to an account in which an account manager has a substantial interest would likely be more readily apparent and therefore more easily detected, which actually creates a disincentive with respect to such practices.

5. Other Issues

We support the Commission's proposal to require account managers to certify in writing that they are aware of and will comply with the requirements of the Reproposed Rules. However, we recommend that the Commission require such certification to be made only to the FCM clearing accounts managed on behalf of the account manager and its customers. Under the Reproposed Rules, an account manager would be required to provide this certification to each FCM executing and/or allocating orders for the account manager. This approach, in our view, will be confusing and duplicative and is unnecessary for customer protection purposes.

Finally, we recommend that the Commission eliminate the requirement that FCMs indicate on each confirmation those trades that were subject to post-execution allocation. Because customers will have consented in advance to this procedure, it is unnecessary to advise them subsequently that their account managers have given post-execution allocation instructions. Moreover, such information is unlikely to be useful to customers and could be difficult or impossible for FCMs to comply with in certain instances. For example, where an order is given up to an FCM for clearing, it is possible that the allocation will have been made before the give-up occurs and the FCM therefore will have no information regarding the allocation.

MAR. 23. 1998 12:42PM GOLDMAN SACHS & CO. NO. 2945 P. 10

****

Goldman Sachs appreciates the opportunity to comment upon the Reproposed Rules. We of course stand ready to provide any further assistance which may be helpful to the Commission in its consideration of this matter.

Sincerely,

Bonnie S. Litt