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COMMENT

April 28, 2003

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

Re: Proposed Amendments to Rule 1.35(a-l)(5) -- Account Identification for Post-Execution Allocation of Eligible Bunched Orders

Dear Ms. Webb:

Morgan Stanley & Co. Incorporated ("Morgan Stanley") appreciates the opportunity to submit these comments on the amendments to Rule 1.35(a-l) recently proposed by the Commodity Futures Trading Commission (the "Commission") for public comment in the Federal Register. 63 Fed. Reg. 12319 (March 14, 2003). In general, these amendments would expand the ability of account managers to bunch orders for execution and to allocate them to individual accounts after the end of the relevant trading session in a number of important respects; streamline and simplify the post-execution order allocation process in such circumstances; and clarify the respective responsibilities of account managers and futures commission merchants ("FCMs") in this area. For the reasons that follow, Morgan Stanley endorses the proposed amendments to Rule 1.35(a-l) and urges the Commission to adopt them as proposed.

I. Relevance of the Proposed Amendments

Morgan Stanley and its numerous affiliates are engaged in a broad range of financial service businesses, including securities and futures brokerage, securities underwriting and distribution, proprietary trading, dealer and market-making activities, and asset management. Many of these activities involve exchange-traded instruments while others occur outside an exchange environment. Morgan Stanley is a registered broker-dealer and FCM and a clearing member of the major futures exchanges with a substantial investment and commitment to the markets maintained by these exchanges. As a result of Morgan Stanley's significant involvement in the exchange markets and our role as a financial intermediary, we have a strong interest in the efficient functioning, liquidity, and integrity of these markets. In that connection, we agree fully with the comment letter filed by the Futures Industry Association (the "FIA") on the proposed amendments. Given that the Commission's proposals will have a very significant impact on several core areas of our business, we are submitting these separate comments as well.

II. Summary of Current Regulatory Requirements

Under current Rule 1.35(a-l)(5), certain eligible classes of account managers may bunch orders for specified categories of customers for execution without specific customer account identification at the time of order placement or at the time of report of execution, subject to meeting various requirements thereunder. Rule 1.35(a-l)(5) requires the account manager to make various disclosures to each eligible customer regarding the allocation methodology, the standard of fairness of allocations, composite or summary data of the trades, and whether the account manager has any proprietary interest in the bunched orders. In addition, before placing an order eligible for post-execution allocation, the account manager must certify in writing to each clearing FCM its compliance with these requirements and identify to each clearing FCM each eligible customer account to which fills will be allocated.

Further, under the current rule, an account manager must create and timestamp an order origination document reflecting the terms of the order and expected allocation thereof, and any subsequent determination to alter any terms or allocation of the order must be documented. Also, each bunch order must be identified by a group identifier or other code on the order ticket at the time of placement. In this regard, the account manager must maintain specified books and records available for inspection, including certain disclosure documents required to be furnished to eligible customers. The current rule also requires contract markets to adopt audit procedures to monitor compliance with the requirements of Rule 1.35(a-l)(5).

III. Need for Amendments to Rule 1.35(a-l)(5)

Morgan Stanley recognizes that the current provisions of Rule 1.35(a-l)(5) set forth an exception to the general requirement that customer account identification be furnished to the clearing FCM at the time of order placement or at the time of report of execution. This requirement has been premised on the Commission's longstanding concern that post-execution allocation may facilitate potential abuses by account managers such as preferential treatment of certain clients or groups of clients or favoring proprietary orders over client orders. See, e.g., 17 C.F.R. Part 1, Appendix C (2002), 62 Fed. Reg. 25470 (May 8, 1997) (Notice of Interpretation and Order Approving NFA Interpretive Notice to NFA Compliance Rule 2-10 Relating to the Allocation of Block Orders for Multiple Accounts).[1]

Our impression is that the industry's experience with the current rule has been decidedly mixed. On the one hand, we are not aware that any abuses or other significant concerns relating to post-execution allocation procedures have been identified in connection with audits or inspections or otherwise since its adoption. On the other hand, the cumbersome nature of the requirements in the current rule has severely reduced the ability and willingness of account managers as well as FCMs to rely on its provisions.

[1] If the Commission determines to adopt the proposed amendments, the Commission should also consider the extent to which these prior pronouncements should be rescinded or modified at the same time.

Based upon the experience of our asset management affiliates[2], we believe that account managers have been increasingly hampered in their ability to achieve equitable trading results for their clients in the prevailing market environment, consistent with their fiduciary responsibilities. In particular, because many account managers trade on behalf of their clients in multiple markets using complex and dynamic strategies, they must be able to allocate futures orders on a post-execution basis with the same degree of flexibility using the same state-of-the-art technology as they allocate orders for other financial products to assure equitable treatment of their clients. For the same reason, account managers must be able to implement post-execution allocation procedures for all their clients, rather than only specified categories of eligible clients. These issues may cause account managers to avoid or limit using domestic exchange-traded futures and options on futures contracts as they seek to satisfy their clients' risk management needs elsewhere. Of course, Morgan Stanley is also cognizant that sufficient safeguards against potential abuses must be present to assure customer protection.

The report prepared by the National Futures Association and the Futures Industry Institute at the Commission's request and released in February 2001, Recommendations for Best Practices in Order Entry and Transmission of Exchange-Traded Futures and Options Transactions (the "Best Practices Recommendations"), recognizes these essential points. Among other things, the Best Practices Recommendations state that the "benefits of post-execution allocation procedures should be extended to all customers of account managers" subject to appropriate safeguards as follows: (i) the account manager is registered or otherwise subject to appropriate regulation; (ii) the account manager has adopted and implemented an equitable allocation methodology that is sufficiently objective and specific to permit independent review of such procedures by the appropriate regulatory or self-regulatory authorities and the account manager's accountants; (iii) the account manager makes available to its customers the general structure and nature of its allocation method; and (iv) the account manager allocates all transactions among its customers no later than the end of the trade date.

Additionally, one of the principal mandates underlying Congressional enactment of The Commodity Futures Modernization Act of 2000 (the "CFMA") is to streamline and simplify unnecessary or burdensome regulation, including with respect to market intermediaries. For example, Section 125 of the CFMA directed the Commission to complete a study of its rules, regulations and interpretations governing the conduct of registrants by December 21, 2001. In response, the Commission has reviewed and modified its rules relating to intermediaries to provide greater flexibility and reduce unwarranted regulatory burdens in a number of areas.[3] It is therefore appropriate that the Commission is revisiting Rule 1.35(a-l)(5) and is proposing these amendments to the current rule.

IV. The Commission's Proposal

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[2] Morgan Stanley's affiliates include a registered investment adviser under the Investment Advisers Act of 1940 and registered commodity trading advisors under The Commodity Exchange Act. Total assets under management for all Morgan Stanley affiliates were approximately $517 billion at November 30, 2002.

[3] See, e.g., 66 Fed. Reg. 53510 (October 23, 2001) (adoption of rules relating to intermediaries of commodity interest transactions).

Morgan Stanley believes that the Commission's proposals appropriately reconcile the competing interests of providing account managers and FCMs with greater flexibility in post-execution order allocation procedures yet providing sufficient safeguards to assure customer protection. We believe that the proposed expansion of the class of eligible customers to include all customers who provide written investment discretion to account managers is appropriate because all customers should be able to benefit from the advantages of bunched orders and account managers typically wish to implement post-execution allocation procedures for all their discretionary accounts consistent with their fiduciary responsibilities to their clients. Morgan Stanley also agrees with the proposed expansion of the class of eligible account managers who would be permitted to bunch orders. As discussed below, we believe that the proposed amendments and the continuing applicability of the antifraud provisions of the Commodity Exchange Act (the "CEA") provide sufficient protections.

We endorse changing the current disclosure requirements to an information availability requirement whereby eligible account managers would make certain specified information available to customers upon request. As noted in the Federal Register release, this requirement has been anomalous because the Commission generally does not require registrants to disclose the mechanics of the process of trading. Id. at 12321. We also support deleting the current requirement that account managers make certain certifications to FCMs. In our experience this requirement is unduly burdensome and has discouraged use of the current procedures without enhancing customer protection. The elimination of the certification requirement also would confirm unequivocally that it is the account manager's obligation to assure that allocations are fair and equitable and not also indirectly an obligation of the FCM(s) that clear the clients' accounts. Both as a legal and as a practical matter, as explained in the FIA comment letter, we reject the notion that an FCM has an independent or collateral responsibility to assess whether an account manager is fulfilling its obligations to treat its clients fairly.

Morgan Stanley believes that the procedures set forth in the rule fully address core concerns about customer protection, consistent with the Best Practices Recommendations. Specifically, under the rule, an allocation methodology must be fair and equitable so that no account or group of accounts may receive consistently favorable or unfavorable treatment and the allocation methodology must be sufficiently objective and specific to permit independent verification of the fairness of the allocations by appropriate regulatory authorities and self-regulatory organizations and by outside auditors. Similarly, the recordkeeping requirements applicable to account managers and FCMs under the rule will permit relevant regulatory authorities and self-regulatory organizations to verify on audit that account managers are complying with the requirements of the rule to assure equitable treatment of their clients over time. As an additional safeguard, if an account manager fails to provide the Commission with requested information that is required to be maintained under the rule, the Commission may prohibit the account manager from submitting orders for execution and prohibit FCMs from accepting orders from such account manager, all without prior notice and hearing. In that connection, as we have noted, the antifraud provisions of the CEA will continue to apply.

V. Conclusion

In sum, Morgan Stanley believes that the proposed amendments would provide account managers and the FCM community with the necessary degree of flexibility essential for the post-execution order allocation process in the current market environment, as well as appropriate customer protections. We therefore urge the Commission to adopt the proposed amendments to Rule 1.35(a-l)(5) as soon as possible. If the Commission or its staff has any questions concerning these comments, please direct them to William F. McCoy of this Firm at (212) 762-6841.

Sincerely,

R. Sheldon Johnson

R. Sheldon Johnson
Managing Director