Proposed Rules

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This section of the FEDERAL REGISTER contains notices to the public of the proposed issuance of rules and regulations. The purpose of these notices is to give interested persons an opportunity to participate in the rule making prior to the adoption of the final rules.

COMMODITY FUTURES TRADING COMMISSION

17 CFR Part 1

Account Identification for Eligible Bunched Orders

AGENCY: Commodity Futures Trading Commission.

ACTION: Proposed rules.

SUMMARY: The Commodity Futures Trading Commission (''Commission'') is reproposing to amend Commission Regulation 1.35(a–1) to allow eligible customer orders to be placed on a contract market without specific customer account identification either at the time of order placement or at the time of report of execution.[1] Specifically, the amendment would exempt from the customer account identification requirements of Regulation 1.35(a–1) (1), (2)(i), and (4) bunched futures and/or futures option orders placed by an eligible account manager on behalf of consenting eligible customer accounts as part of its management of a portfolio also containing instruments which are either exempt from regulation pursuant to the Commission's regulations or excluded from regulation under the Commodity Exchange Act (''Act''). The proposed rule would permit orders entered on behalf of these accounts to be allocated no later than the end of the day on which the order is executed.

DATES: Comments must be received on or before March 9, 1998.

ADDRESSES: Interested persons should submit their views and comments to Jean A. Webb, Secretary, Commodity Futures Trading Commission, Three Lafayette Centre, 1155 21st Street, N.W., Washington, D.C. 20581. In addition, comments may be sent by facsimile transmission to facsimile number (202) 418–5521, or by electronic mail to secretary@cftc.gov. Reference should be made to ''Eligible orders.''

FOR FURTHER INFORMATION CONTACT: Duane C. Andresen, Special Counsel, Division of Trading and Markets, Commodity Futures Trading Commission, Three Lafayette Centre, 1155 21st Street, N.W., Washington, D.C. 20581. Telephone: (202) 418–5490.

SUPPLEMENTARY INFORMATION:

Table of Contents

I. Background

A. Current Regulatory Requirements

Commission regulations specify that customer orders must be recorded promptly and include customer account identification at the time of entry and the time of report of execution. These recordkeeping requirements, in effect since March 24, 1972, permit a specific customer's order to be traced at each stage of the order processing system and help to prevent the improper allocation of trades and other abuses. Specifically, Commission Regulation 1.35(a–1)(1) requires that each futures commission merchant (''FCM'') and each introducing broker (''IB'') receiving a customer's order immediately prepare a written record of that order, which includes an account identifier for that customer. Regulation 1.35(a–1)(2)(i) requires that each member of a contract market who receives a customer's order on the floor of a contract market that is not in writing immediately prepare a written record of that order, including the appropriate customer account identification. Regulation 1.35(a–1)(4) requires, among other things, that each member of a contract market reporting the time of execution of a customer's order from the floor of a contract market include the account identification on a written record of that order.

B. Proposed Amendment to CME Rule 536

By letters dated February 24, 1992, CME submitted both a proposed amendment to CME Rule 536 pursuant to Section 5a(12) of the Act,[2] 7 U.S.C. 1 *et seq.*, and a petition for rulemaking to amend Commission Regulation 1.35(a–1) pursuant to Commission Regulation 13.2.[3] As discussed below, the Commission published requests for comments on both submissions.

The proposed CME rule amendment would have exempted from the customer account designation requirement certain orders entered by investment advisers registered with the Securities and Exchange Commission (''SEC'') pursuant to the Investment

[1] The Commission published a proposed amendment to Regulation 1.35(a–1) on May 3, 1993. 58 FR 26270 (May 3, 1993).

[2] Now redesignated as Section 5a(a)(12)(A).

[3] The Exchange submitted additional information regarding the proposed rule amendment in letters dated May 7, 1992, and August 12, 1992. By letter dated August 20, 1992, the Division of Trading and Markets posed a series of questions to the Exchange. The CME responded in a letter dated September 25, 1992.

Advisers Act of 1940, 15 U.S.C. 80b *et seq.* [1988], and banks, insurance companies, trust companies, and savings and loan institutions subject to federal or state regulation (''account managers'').[4] These orders could have been placed only for certain specified institutional accounts whose owners had been notified in writing that their orders were being placed without customer account designations. The orders would have been required to be allocated among participating accounts prior to the end of the day. Finally, the individual or firm directing the allocation of the orders could not have a proprietary interest in any account that received any part of the order, and no related-party account could receive any part of the order.

On June 8, 1992, the Commission published the proposed amendment to CME Rule 536 for public comment.[5] The Commission received 31 comments in response to the CME's proposal. Twenty-six of the comments evidenced support for the proposed rule amendment, four were opposed to the amendment,[6] and one recommended caution.[7] Those comments were addressed in the Commission's subsequent proposed amendment to Regulation 1.35 and are not addressed herein.

C. Proposed Amendment to Regulation 1.35(a–1)

On May 3, 1993, the Commission published proposed amendments to Regulation 1.35(a–1) for public comment.[8] In addition to amending Regulations 1.35(a–1)(1), (2), and (4), the Commission proposed to add paragraphs 1.35(a–1)(5) and (6). Paragraph (5) addressed the placement and allocation of bunched orders generally and the use of predetermined allocation formulas. Paragraph (6) was the Commission's followup to CME's proposal to permit the allocation of certain bunched orders at the end of the day.

1. Predetermined Allocation Formulas

Proposed Regulation 1.35(a–1)(5) would have permitted the placement of a bunched order for multiple customer accounts without individual customer account identification at the time of entry and the time of report of execution, subject to certain requirements.[9] Proposed Regulation 1.35(a–1)(5) is being withdrawn because it has been superseded. On May 9, 1997, the Commission published a Notice of Interpretation and Approval Order approving the National Futures Association (''NFA'') Interpretative Notice to NFA Compliance Rule 2–10 Relating to the Allocation of Block Orders for Multiple Accounts and providing additional Commission guidance regarding bunched orders and allocation procedures.[10] The guidance provided therein has been published as Appendix C to Part One of the Commission's regulations.

2. End-of-Day Allocation to Eligible Customers

Under proposed Regulation 1.35(a–1)(6), contract markets could have submitted rules for Commission approval that would have exempted certain orders from the requirement that a specific customer account be identified at the time of entry and the time of report of execution if specified requirements were met. These orders could have been allocated at the end of the day. The specific requirements of the proposal addressed: (a) Eligible orders, (b) eligible account managers, (c) eligible customers, (d) account certification, (e) allocation requirements, (f) account manager recordkeeping, and (g) contract market rule enforcement programs. The Commission stated that the proposed regulation would encourage and facilitate institutional participation in the futures markets subject to customer protection requirements that were consistent with the sophistication of the institutional customers.

The Commission received 34 comments in response to the proposed amendments to Regulation 1.35(a–1).[11] Commenters included eleven FCMs;[12] one investment adviser registered with the SEC;[13] seven firms registered with both the Commission and the SEC;[14] four commodity trading advisors (''CTA'');[15] three industry associations;[16] the CME, the Chicago Board of Trade (''CBT''), and the NFA.[17]

Most commenters found the proposed rule burdensome and too restrictive to be of value. In particular, these commenters objected to the proposed requirement for an intermarket trading strategy involving securities and to the recordkeeping and certification requirements. Two comments from the same commenter opposed the proposal,[18] and one raised concerns about money laundering.[19] The Commission has carefully reviewed the comments received and, as a result, has modified and clarified the proposed amendments to Regulation 1.35(a–1). Comments addressing specific areas and an explanation of the Commission's revisions are discussed below.

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[4] The term *account manager* hereinafter is used to include investment advisers and other persons identified in the proposed regulation, and their principals, if any, who would place orders and direct the allocation thereof in accordance with the procedures set forth in the reproposed amendment.

[5] 57 FR 24251.

[6] Commenters opposed to approval of the proposed rule amendment included a Commission Administrative Law Judge; his law clerk; the Director, Office of Financial Enforcement, Department of the Treasury; and the Chief, White-Collar Crimes Section, Criminal Investigative Division, Federal Bureau of Investigation. These commenters expressed concern that, by weakening the audit trail, the proposal could facilitate misallocation, money laundering and tax evasion.

[7] The United States Attorney for the Northern District of Illinois urged that the Commission ''exercise great care before taking any action that could provide any opportunity for fraud, self-dealing, or other criminal activity.''

[8] 58 FR 26274 (May 3, 1993).

[9] Those requirements included providing an allocation formula for allocating the fills fairly among the participating accounts. Directing profitable fills to favored accounts and unprofitable fills to unfavored accounts (preferential allocation) is a violation of Section 4b of the Act. In the Matter of GNP Commodities, Inc., et al., [1990–1992 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 25,360 at 39,214 (CFTC August 11, 1992); In the Matter of Lincolnwood Commodities, Inc., of California, et al., [1982–1984 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 21,986 at 28,246 (CFTC January 31, 1984).

[10] 62 FR 25470 (May 9, 1997).

[11] Only those comments addressing proposed paragraph 1.35(a–1)(6) are addressed herein.

[12] BA Futures, Inc. (''BA''); Cargill Investor Services (''Cargill''); Credit Agricole Futures, Inc. (''Credit Agricole''), which is also registered as a CTA; Dean Witter Reynolds, Inc., Futures Division (''Dean Witter''); First Boston Corporation (''First Boston''); Lind-Waldock & Company (''Lind-Waldock''); PaineWebber Incorporated (''PaineWebber''); Refco, Inc. (''Refco''); Rodman & Renshaw, Inc. (''Rodman''); Sanwa-BGK Futures, Inc. (''Sanwa-BGK''); and Saul Stone and Company (''Saul Stone'').

[13] Pacific Investment Management Company (''Pacific'').

[14] Bear, Stearns & Co., Inc. (''Bear Stearns''); Flaherty & Crumrine Inc. (''Flaherty''); Goldman, Sachs & Co. (''Goldman Sachs''); Indosuez Carr Futures, Inc. (''Carr''); Merrill Lynch; Morgan Stanley & Co. (''Morgan Stanley''); and TSA Capital Management (''TSA'').

[15] Campbell Company (''Campbell''); John W. Henry & Co., Inc. (''John Henry''); Leland O'Brien Rubinstein Associates Inc. (''Leland''); and Sunrise Commodities, Inc. (''Sunrise'').

[16] Futures Industry Association (''FIA''), Managed Futures Association (''MFA''), and Investment Company Institute (''ICI'').

[17] The Commission also received comments from the New York City Bar Association (''N.Y. Bar'') and a law firm, Abramson and Fox.

[18] The commenter, who submitted two comments, was a Commission Administrative Law Judge. He opposed the proposal because of the potential for fraud, money laundering and tax evasion. He further commented that the industry has failed to articulate a compelling need and that the real reason to do so, the desire to increase account managers' flexibility and conform commodity regulation to security regulation, does not justify adoption of a system so open to abuse.

[19] The Chief, Money Laundering Section, Criminal Division, Department of Justice, asked that the Commission consider the proposal's impact on future money laundering and other law enforcement investigations.

II. Reproposed Amendment to Commission Regulation 1.35(a–1)

The Commission is reproposing to amend Regulation 1.35(a–1). Under reproposed Regulation 1.35(a–1)(5) (formerly 1.35(a–1)(6)), a specific customer's account identifier need not be recorded at the time an eligible bunched order (''eligible order'') is placed or upon report of execution, and the order may be allocated by the end of the day on which it is executed, provided that certain requirements are met. In addition, the order must be handled in accordance with contract market rules that have been submitted to the Commission and approved or permitted into effect pursuant to Section 5a(a)(12)(A) of the Act and Regulation 1.41. The Commission intends that this reproposal include certain core regulatory protections while providing meaningful regulatory relief in a manner which is responsive to the comments previously received. In the discussion below, the Commission sets forth each of the components of its 1993 proposal, a summary of the comments then received, and the manner in which the reproposal addresses the same issue.

A. Eligible Orders

1. Proposed Regulation 1.35(6)(a–1)(i)

Proposed Regulation 1.35(6)(a–1)(i) would have required that orders entered and allocated pursuant to the proposed regulation must be intermarket orders. The term *intermarket* order was defined as a futures or futures option order entered on behalf of an eligible customer as part of a bona fide intermarket trading strategy also involving securities. The term ''securities'' was defined to mean equity or debt securities within the meaning of Section 2(1) of the Securities Act of 1933.

This requirement was based on the stated rationale for allowing post-trade allocation, which was to permit account managers to provide equivalent treatment to customers' accounts traded pursuant to strategies involving activity in both futures markets and securities markets. For example, if a securities trade is allocable at the end of the day and the account manager follows a strategy of buying securities and selling futures, with the futures order to be executed throughout the day, the account manager may need to await the results of all transactions before allocating to the accounts so as to provide equivalent treatment. Similarly, for strategies such as duration management, where futures transactions are executed on the basis of a change in interest rates that affects the price of the bonds in an underlying portfolio, the procedure could be used to maintain positions of a specified duration under circumstances when this result could not be achieved through the use of a predetermined allocation formula.

2. Comments Received

With regard to the proposal's description of eligible orders, most commenters focussed on two issues: the definition of ''intermarket'' and the definition of ''securities.'' Numerous commenters suggested that the proposal should not be limited to intermarket strategies based on a securities requirement and suggested expanding the definition of ''intermarket'' to include trading strategies that did not involve securities directly.[20] In addition to concerns about the definition of intermarket, several commenters voiced the opinion that the definition of ''securities'' was too restrictive.[21] Several commenters indicated that the proposal appeared to require a transaction test, *i.e.*, that the securities and futures executions would be required to occur simultaneously.[22]

3. Reproposed Regulation 1.35(a–1)(5)(i)

After consideration of the comments, the Commission believes that it would be appropriate to delete the term ''intermarket'' as the descriptive term used to identify eligible orders. The Commission also agrees with the commenters in recognizing that appropriate multi-market investment management strategies can involve futures and/or futures options and financial instruments other than securities. Thus, the Commission is proposing to eliminate the requirement that the trading strategy also involve securities. The Commission also wants to make clear that eligible orders would be subject to a portfolio test and not a transaction test.

As previously noted, the overriding rationale for allowing post-trade allocation is to permit equivalent treatment of customers' accounts traded pursuant to strategies involving trading activity or changes in valuation in more than one market. The Commission believes that the account manager, in his or her role as a fiduciary, should be permitted to determine that the portfolio management strategy requires the placement of this type of order. Generally, this situation exists when accounts are being traded in more than one market and the account manager must review the results of trading activity in all markets prior to directing order allocation in order to assure fairness. Of course, it would not be permissible for a purported portfolio to be established solely to obtain the relief being proposed. Rather, the other financial instruments included in the portfolio must have a legitimate financial relationship to the futures or futures option orders for post-trade allocation to be appropriate.

Where trades are executed only on domestic futures exchanges, the account manager should be able to achieve equivalent treatment of customers' accounts while complying with either the existing customer account identifier requirements of Regulation 1.35(a–1)(1) and (2)(i) or the predetermined allocation formula exceptions thereto as described in Appendix C to Part One of the Commission's regulations. In particular, for futures-only orders executed on one domestic futures exchange, average pricing would be available to provide fair treatment among customers. Accordingly, the Commission is proposing that to be eligible, orders must be placed as part of the management of a portfolio also containing instruments which are either exempt from regulation pursuant to the Commission's regulations or excluded from Commission regulation under the Act.

The Commission has been advised that there may be instances where a CTA placing exchange traded futures-only orders on more than one futures exchange may need post-trade allocation in order to achieve equivalent treatment of customers' accounts. The Commission requests comments with regard to whether that relief is necessary. Any comments should provide specific examples illustrating why the use of predetermined allocation formulas or average pricing is insufficient to provide fair treatment.

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[20] Bear Stearns, Dean Witter, Goldman Sachs, Carr, Morgan Stanley, Lind-Waldock, TSA, NFA, ICI, N.Y. Bar, CME and CBT.

CME stated that many other instruments, such as forex and commodity and interest rate swaps, are used as part of investment strategies and should not be excluded from the proposed amendments. CBT commented that the exemption should cover strategies that include foreign products and off-exchange products such as swaps. The ICI stated that the ''intermarket'' requirement should be deleted and that all orders entered on behalf of investment companies that are registered with the SEC under the Investment Company Act of 1940 should be presumed to be eligible orders.

[21] Bear Stearns, Dean Witter, Lind-Waldock, Merrill Lynch, and Pacific.

[22] The CME noted that a requirement that the futures and securities executions must occur simultaneously would inhibit the use of duration adjustments, overlay, and other strategies. Goldman Sachs commented that the Commission should make clear that the proposed rule did not require that the futures transaction be related to specific securities transactions, provided that it is related to the management of a securities portfolio. Morgan Stanley voiced similar concerns.

B. Eligible Account Managers

1. Proposed Regulation 1.35(a–1)(6)(ii)

Proposed Regulation 1.35(a–1)(6)(ii) would have required that the person placing and/or directing the allocation of an eligible order and its principal, if any, (''account manager'') must be one of the following which had been granted investment discretion with regard to the eligible customer accounts:

(i) an investment adviser registered with the SEC pursuant to the Investment Advisers Act of 1940, or

(ii) a bank, insurance company, trust company, or savings and loan association subject to federal or state regulation.

As proposed, the class of persons eligible to place intermarket orders and direct the end-of-day allocation thereof would have been identical to that suggested by CME. The Commission believed that, when managing multiple accounts, these entities might be better able to achieve similar results for institutional accounts being traded pursuant to a program which involved multi-market trading strategies. Under the proposed regulation, account managers for these types of accounts would have been able to allocate futures and futures option trades in the same manner as they allocated trades on securities exchanges and over-the-counter markets.[23] Additionally, these entities' fiduciary activities were subject to oversight by various state or federal regulatory agencies.

2. Comments Received

Numerous commenters suggested that the list of eligible account managers be expanded to include other entities. The suggested additional entities include CTAs,[24] foreign investment advisers subject to regulation in their home jurisdiction,[25] non-U.S. investment advisers registered with the Commission or otherwise exempt from registration pursuant to Regulation 30.10,[26] and investment advisers exempt from SEC registration under Section 203(b)(3) of the Investment Advisers Act of 1940.[27] Finally, CBT proposed that the proposal should be modified to afford sufficient flexibility to allow exchanges to include any account manager that is regulated and subject to fiduciary liability.

3. Reproposed Regulation 1.35(a–1)(5)(ii)

After consideration of the comments, the Commission believes that it is appropriate to expand the list of eligible account managers to include CTAs registered with the Commission pursuant to the Act.[28] Because CTAs also attempt to achieve equivalent treatment of customers' accounts traded pursuant to strategies involving trading activity in more than one market, the Commission believes that the relief afforded by this provision should be extended to these account managers. In addition, CTAs are subject to Commission and NFA regulatory requirements and oversight, including periodic audits by the NFA.

The Commission is not including as eligible account managers non-U.S. investment advisers registered with the Commission or otherwise exempt from registration pursuant to Regulation 30.10 and foreign investment advisers subject to regulation in their home jurisdiction. The Commission is concerned about potential difficulty in auditing these entities and in obtaining documentation required to be made available pursuant to the recordkeeping requirements discussed below. The Commission specifically requests comments concerning this determination. The Commission also requests comments with regard to its determination not to include, at present, investment advisers exempt from SEC registration under Section 203(b)(3) of the Investment Advisers Act of 1940.

C. Eligible Customers

1. Proposed Regulation 1.35(a–1)(6)(iii)

(a). 1.35(a–1)(6)(iii)(A)—Types of Customers

Proposed Regulation 1.35(a-1)(6)(iii)(A) provided that intermarket orders could be allocated to accounts maintained by any of the following institutional customers:

(i) An Investment Company registered as such under the Investment Company Act of 1940, 15 U.S.C. 80a *et seq.* [1988].

(ii) A bank, trust company, insurance company or savings and loan association subject to federal or state regulation.

(iii) An account for which a bank, trust company, insurance company or savings and loan association subject to federal or state regulation is a fiduciary vested with investment discretion.

(iv) A corporate qualified pension, profit sharing, or stock bonus plan subject to Title 1 of the Employee Retirement Income Security Act of 1974 (''ERISA''), or any plan defined as a governmental plan in Section 3(32) of Title 1 of such Act, but not including a self-directed plan.

(v) An educational endowment, foundation, charitable institution or trust which is organized or qualifies under Section 501(c)(3) of the Internal Revenue Code with net assets of more than $100 million.

This group of proposed eligible customers was substantially the same as that included in the proposed amendment to CME Rule 536. The CME and certain institutional customers represented that professional managers of multi-market portfolios needed the flexibility afforded by CME's proposed rule amendment to treat similarly managed accounts fairly. Further, the Commission believed that those customers were institutional investors whose accounts were subject to other regulatory regimes or a portfolio size requirement and who participated in multi-market investment strategies. Therefore, these customers could benefit from use of the proposed regulation. The Commission further believed the proposed eligible customer accounts were owned by entities with the capacity to review and evaluate the accounts' trading activity and results.

(b). 1.35(a–1)(6)(iii)(B)—Proprietary Interest

Proposed Regulation 1.35(a–1)(6)(iii)(B) provided that the following persons may have no interest in any account that receives any part of such order or in any related securities account:

(i) The account manager;

(ii) The futures commission merchant allocating the order;

(iii) Any general partner, officer, director, or owner of ten percent or more of the equity interest in the account manager or the futures commission merchant allocating the order;

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[23] *See, e.g.,* Interpretation 88–3 of New York Stock Exchange Rule 410(a)(3): ''Member organizations may accept block orders and permit investment advisors to make allocations on such orders to customers and remain in compliance with Rule 410(a)(3) provided that the organizations receive specific account designations or customer names by the end of the business day.'' *See also* Securities and Futures Authority Rule Book. Rule 5–41 allows a firm to aggregate customers' orders when it is unlikely to disadvantage the customer and the firm has disclosed that orders may be aggregated. Rule 5–34(13), averaging of prices, allows a firm to execute a series of transactions within a 24-hour period to meet orders it has aggregated. When a firm has aggregated orders, Rule 5–42 specifies that the firm must not give unfair preference and if all the orders cannot be satisfied, the firm generally must give priority to satisfying customer orders.

[24] Campbell, First Boston, John Henry, Merrill Lynch, Morgan Stanley, PaineWebber, FIA, and NFA. The N.Y. Bar recommended that CTAs be considered after the rule had been evaluated.

[25] First Boston, Goldman Sachs, Merrill Lynch, and Morgan Stanley.

[26] Carr and N.Y. Bar.

[27] First Boston and N.Y. Bar.

[28] Where applicable, the employing firm of an account manager should have appropriate internal controls in place to address the added discretion that the account manager will be able to exercise pursuant to this proposal.

(iv) Any employee or associated person or limited partner of the account manager or the futures commission merchant allocating the order who affects or supervises the handling of the order;

(v) Any business affiliate that, directly or indirectly, controls, is controlled by, or is under common control with, the account manager or the futures commission merchant allocating the order;

(vi) An employee benefit plan of the account manager, the futures commission merchant allocating the order, or an affiliate, as defined in subparagraph (v) above; or

(vii) Any spouse, parent, sibling, or child of the foregoing persons.

The Commission believed, based on its experience with misallocation of trades, that the ability to allocate fills between customer and proprietary accounts subsequent to execution would have created an unacceptably high potential for favoring the proprietary accounts.[29] The Commission further believed that the ability to allocate fills subsequent to execution while maintaining a proprietary interest in a related securities account also would have created an unacceptably high potential for abuse.[30] The Commission, therefore, believed that prohibiting the account manager, the allocating FCM, and their related or affiliated persons, from having any interest in either the futures or a related securities account was a preventive approach that effectively eliminated the possibility of preferential allocation for personal gain.

2. Comments Received

(a). 1.35(a–1)(6)(iii)(A)—Types of Customers

Numerous commenters suggested that the list of eligible customers be expanded to include other entities. Several commenters suggested that the list be expanded to include ''appropriate persons'' as described in Section 4(c)(3) of the Act[31] or eligible swap participants.[32] One commenter suggested expanding the list to include either ''appropriate persons'' or ''accredited investor'' as set forth in Rule 501 (Regulation D) of the Securities Act of 1993.[33] Four commenters stated that domestic and foreign corporations should be eligible customers.[34] Commenters also suggested including large, sophisticated corporate investors[35] and individuals or entities with assets in excess of $100 million.[36] One commenter suggested including a CTA acting for its proprietary account.[37] Finally, one exchange recommended expanding the list to include ''appropriate persons'' and all those who qualify for exemptive relief under Commission Regulation 4.7.[38]

(b). 1.35(a–1)(6)(iii)(B)—Proprietary Interest

Many commenters believed the provision limiting proprietary interests was overly restrictive. Commenters stated that it would inhibit access to U.S. markets[39] and would result in unfair customer treatment.[40] Two commenters pointed out that the provision would exclude certain publicly owned organizations from becoming eligible customers.[41] Most commenters stated that the limit on proprietary interest should be less than 10 percent, which is consistent with the definition of proprietary interest contained in Commission Regulation 1.3(y).[42] One commenter, however, stated that a de minimis provision exempting interests of less than one percent in participating accounts would be adequate.[43]

3. Reproposed Regulation 1.35(a–1)(5)(iii)

(a). 1.35(a–1)(5)(iii)(A)—Types of Customers

After consideration of the comments, the Commission believes that it is appropriate to expand the list of eligible customers. As reproposed, the group of eligible customers would be substantially similar to those entities defined as ''eligible participants'' for purposes of Part 36—Exemption of Section 4(c) Contract Market Transactions, of the Commission's regulations, except that sole proprietorships, floor brokers, floor traders, and natural persons, as well as self-directed employee benefit plans, would not be included as eligible customers.

As the Commission stated in promulgating the final rules for Part 36, the list of ''eligible participants'' was modeled on the list of ''appropriate persons'' set forth in Section 4(c)(3)(A) through (J) of the Act and on the definition of ''eligible swap participant'' under Part 35 of the Commission's regulations.[44] Having previously considered this group of entities and

[29] *See, e.g.*, In the Matter of GNP Commodities, Inc., et al., [1990–1992 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶25,360 (CFTC August 11, 1992); In the Matter of Lincolnwood Commodities, Inc., of California, *et al.*, [1982–1984 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶21,986 (CFTC January 31, 1984); *Parciasepe* v. *Shearson Hayden Stone, Inc., et al.*, [1980–1982 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶21,461 (CFTC August 18, 1982); *Wilke, et al.*, v. *Winchester-Hardin Oppenheimer Trading Co., et al.*, [1977–1980 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶20,605 (CFTC December 29, 1977).

[30] The CME's proposed rule amendment would have prohibited the individual or firm directing the allocation of the order from having a proprietary interest in any account that received any part of such order. Commission Regulation 1.3(y) defines a proprietary account to include the ownership of ten percent or more of a futures or option trading account. Therefore, the proposed CME amendment would have permitted the person or firm directing the allocation to have an interest of less than ten percent of one or more of the accounts receiving part of the allocated order.

[31] Carr, Pacific, FIA, and CME. CME also proposed expanding the list to include foreign corporations.

[32] Dean Witter, First Boston, Lind-Waldock, and Morgan Stanley. Goldman Sachs suggested that the eligible customer restriction be eliminated because it would require account managers to treat their customers in a disparate manner and to disadvantage those customers who were not permitted to be included in a bunched order. In the alternative, Goldman Sachs recommended that the list be expanded to include eligible swap participants.

[33] Bear Stearns.

[34] Bear Stearns, Dean Witter, Lind-Waldock, and TSA.

[35] Flaherty.

[36] N.Y. Bar.

[37] First Boston. The N.Y. Bar suggested including FCMs, IBs, CTAs, and CPOs trading for their own accounts as eligible customers.

[38] CBT.

[39] Credit Agricole and Refco.

[40] Bear Stearns asserted that it would be unfair to exclude otherwise eligible types of funds because the account manager was required to have a small interest in a partnership or contributed seed money at the start up of a mutual fund or was paid a management fee by the fund.

[41] Flaherty stated that a registered investment company would not be an eligible customer, for instance, if the investment adviser made a seed money investment in the initial shares issued by the fund or if officers of the account manager served on the Board of Directors of the fund and, held shares of the fund. In addition, it would be impossible for the account manager or the FCM allocating the order to know with certainty that no relative of any of the listed persons held any shares in a publicly owned corporation for whose account the transaction was executed.

The ICI commented that the practical effect of the provision would be to disqualify most, if not all, investment advisers to investment companies from relying on the proposal. Additionally, it would be almost impossible for such investment advisers to assure compliance on an ongoing basis and it would impede the investment adviser's ability to act in the best interests of investment companies that were clients.

[42] Dean Witter, First Boston, Lind-Waldock, Pacific, FIA, N.Y. Bar, CBT, and CME. CME also suggested removing from the list of entities subject to the no interest provision ''[a]ny business affiliate that, directly or indirectly, controls, is controlled by, or is under common control with, the account manager or the futures commission merchant allocating the order.'' The CME posited that removing this provision would prevent managed accounts from being unnecessarily excluded from eligibility.

[43] Flaherty stated that while an FCM who is also an underwriter and a market maker for securities might want a higher percentage interest, permitting an owner of up to 10 percent of the interest in the account manager to hold an unlimited interest in a participating account would seem to invite possible abuse.

[44] 60 FR 51328 (October 2, 1995).

determined that they are eligible to participate both in exempt transactions and in swaps, the Commission believes that they are sufficiently sophisticated to monitor the results of post-trade allocations in their accounts. The Commission is incorporating into this paragraph the requirement that these entities, in order to be considered eligible customers, must have consented in writing that eligible orders may be placed, executed, and allocated for their accounts. The issue of consent is discussed below.

The Commission does not believe, however, that accounts owned by sole proprietorships, floor brokers, floor traders, natural persons, or self-directed employee benefit plans should be included as eligible customers. The Commission believes that the eligible customers should be institutional or other comparatively large entities whose accounts are subject to other regulatory or management regimes and who may participate in multi-market investment strategies. Although the Commission recognizes that natural persons meeting certain asset or net worth standards may be sufficiently sophisticated to participate, the Commission believes that preferential allocations would be more likely to occur if accounts owned by individuals were included in eligible orders.[45] The Commission requests comments regarding the proposed exclusion of natural persons as eligible customers.

(b). 1.35(a–1)(5)(iii)(B)—Proprietary Interest

After consideration of the comments, the Commission has determined to modify the proposed provisions regarding ownership interest in any account that receives any part of an eligible order or in any related securities account. The Commission is deleting from the reproposal the interest requirement as it applies to any related securities account. As reproposed, the regulation requires that there be a portfolio containing instruments which are either exempt from regulation pursuant to the Commission's regulations or excluded from regulation under the Act rather than a related securities account.

The Commission also is proposing to increase the acceptable level of ownership interest in any account that receives any part of an eligible order from no interest to an interest of less than ten percent, which is similar to the Commission's definition of proprietary interest as set forth in Regulation 1.3(y). The Commission is aware that the account manager may have ''seed'' money invested in the eligible account or, in fact, may invest in the account in order to attract other investors. In any event, the Commission believes that application of the less than ten percent restriction to the listed participants is an appropriate provision that would neither unduly restrict the placement of eligible orders nor increase the incentive to misallocate.

Finally, the Commission is proposing to delete the following as one of the entities subject to the interest restriction: an employee benefit plan of the account manager, the futures commission merchant allocating the order, or an affiliate. These plans are subject to strict ERISA regulations.

D. Account Certification

1. Proposed Regulation 1.35(a–1)(6)(iv)

Proposed Regulation 1.35(a–1)(6)(iv)(A) required that the account manager, before placing the initial order pursuant to this paragraph, certify the following, in writing, to the FCM allocating the order:

(i) The account manager had no interest in any account to which any part of the order may be allocated or in any related securities account.

(ii) The account was owned by an eligible customer.

(iii) The customer had consented in writing that orders may be executed and allocated in accordance with this regulation.

(iv) Orders for such account would be intermarket orders for which it would be impracticable to pre-file a predetermined allocation formula.

(v) Records required by paragraph (a–1)(6)(vi)(A) of the regulation would be made available to the Commission or Department of Justice upon request of any representative thereof.

In addition, proposed Regulation 1.35(a–1)(6)(iv)(B) required that the account manager, before placing the initial order pursuant to this paragraph, must provide the FCM allocating the order with a list of eligible accounts and their related securities accounts.

The Commission believed that these safeguards addressed several purposes of the proposed regulation and were intended to reduce the likelihood of misallocation. In order to encourage compliance with the proposal's requirements, the account manager placing intermarket orders would have been required to certify to the FCM allocating the order that he or she had no interest in any account to which any part of an intermarket order may have been allocated or in any related securities account. The account manager also would have been required to certify that the accounts to which intermarket orders would be allocated were owned by eligible customers. These one-time certification requirements would have helped to assure that personal or proprietary accounts were not included among the accounts to which intermarket order allocations were made.

With regard to customer consent, the Commission believed that notification was insufficient and that these institutional accounts should have the opportunity to consent affirmatively to participate in the intermarket allocation procedure.[46] The Commission believed that customer consent was an important tool in assuring adequate customer oversight of trading activity. Drawing upon comments that the account controller had the relevant relationship with the customer for purposes of obtaining consent, the Commission believed that the account manager would be the appropriate party to obtain that consent and so certify to the FCM so that the FCM could assure that intermarket allocations were made only to the eligible accounts. The consent could have been contained in account opening documents or obtained separately.

The proposed amendment was designed for the benefit of institutional accounts that were being traded pursuant to a strategy that involved related positions in both the futures and securities markets. The Commission believed that, whenever possible, the account manager should place and allocate the order by use of a predetermined allocation formula. The intermarket order allocation procedure was available where use of the predetermined allocation formula would not permit the account manager to attain equitable results. Thus, the Commission believed that a one-time certification that orders placed would be intermarket orders for which it would be impracticable to pre-file a predetermined allocation formula was appropriate.

The use of the post-trade order allocation procedure would have been limited to eligible accounts participating in regulated multi-market trading and both the futures and the related securities accounts would have to have

[45] A review of preferential allocation cases reveals that misallocations, when they occur, often are made to personal or proprietary accounts or to accounts owned by family members.

[46] The CME's proposed amendment to Rule 536 would have required that the FCM notify the identified eligible account owners that orders for those accounts could be bunched and entered without individual customer account identification and allocated at the end of the day.

been identified to the FCM allocating the order.[47] Additionally, the proposed regulation contained a requirement that the account manager agree that the records discussed in paragraph (vi)(A) of the proposed regulation would be made available to specified government agencies upon request.[48]

2. Comments Received

Two commenters stated that all five certifications were unnecessary and duplicative.[49] Numerous commenters opposed the requirement that the account manager certify that the customer had consented in writing that intermarket orders may be executed and allocated, stating that notification would be sufficient.[50] Commenters also stated that the requirement to obtain consent would deter account managers from utilizing the markets in this manner[51] and that it is inconsistent with practices in other markets[52] and with the ability of account managers to monitor client activity and to perform in the client's best interest.[53] One commenter agreed that customer consent should be in writing.[54] Several commenters opposed the requirement that the account manager certify that the orders would be intermarket orders[55] for which it would be impracticable to pre-file a predetermined allocation formula.[56]

Numerous commenters stated that the requirement that the account manager must provide the FCM with a list of eligible accounts and their related securities accounts should be eliminated. Commenters felt that this requirement would result in the disclosure of proprietary information,[57] would serve no useful purpose,[58] and would be overly burdensome because of the potentially large number of accounts at issue.[59]

3. Reproposed Regulation 1.35(a–1)(5)(iv)

After consideration of the comments received, the Commission has determined to reduce the required account manager certifications to one: any account manager placing eligible orders must certify, in writing, to each FCM executing and/or allocating any part of an eligible order, that he or she is aware of the provisions of this paragraph and is, and will remain, in compliance with the requirements therein. The Commission intends that this certification would encourage compliance by account managers and need be made only once to each applicable FCM, not on an order-by-order basis.[60]

The Commission believes that the responsibility for compliance with the eligible order provisions should generally fall on the account manager and his or her principal, if applicable.[61] The Commission has become convinced that little regulatory benefit or additional customer protection would accrue from requiring the FCM to obtain other account manager certifications. The extent of the account manager's compliance with these requirements would be determined during audits and on a for-cause basis.

On the topic of customer consent, the Commission continues to believe that notification alone is insufficient and that these eligible accounts should have to consent affirmatively prior to participating in the post-trade allocation of eligible orders. This is particularly true in the context of the reproposal, which has streamlined and deleted many previously proposed requirements. As the Commission stated in the proposed rule, the account manager is the appropriate party to obtain that consent, either in account opening documents or separately.[62]

The Commission has eliminated the requirement that the account manager must provide the FCM allocating the order with a list of related securities accounts. However, the reproposal continues to require that the account manager must provide a list of eligible futures accounts to the FCM allocating the order. This requirement should enable the FCM to assure that allocations are made only to eligible accounts.

E. Allocation

1. Proposed Regulation 1.35(a–1)(6)(v)

Proposed Regulation 1.35(a–1)(6)(v) required the following:

(1) Intermarket orders allocated pursuant to the regulation must be designated as such on the order at the time of entry.

(2) Intermarket orders must be identified on contract market trade registers and other computerized trade practice surveillance records.

(3) The account manager and the FCM allocating the order must allocate fills from intermarket orders to eligible participating customer accounts prior to the deadline for final submission of trade data to clearing on the day the intermarket order is executed.

(4) The FCM allocating the order must assure that all intermarket orders are allocated to eligible customer accounts.

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[47] The identification of both the futures and securities accounts was believed to be necessary to assure that (1) use of the allocation procedure was restricted to eligible accounts participating in multi-market trading and (2) the related securities account was known in the event it became necessary to review the trading in both markets for possible violative activity.

[48] The Commission, although not the primary regulator of the account manager, recognized that it might require records of transactions in other markets which would not otherwise have been readily available in order to review allegations of preferential allocation.

[49] CBT and CME. In addition, Morgan Stanley commented that, since it was the account manager's obligation to obtain the written consent, it seemed redundant to require that the FCM obtain such a certification.

[50] Dean Witter, Lind-Waldock, Pacific, PaineWebber, TSA, and FIA. Bear Stearns stated that the proposal should be clarified so that customer consent could be given when the customer signs the investment manager contract with the account manager and further stated that, for those customers with existing contracts, notification with the right of the customer to affirmatively opt out should be sufficient.

[51] Credit Agricole and PaineWebber.

[52] Credit Agricole, Pacific, and CME.

[53] Leland. Carr asserted that requiring the expert (account manager) to get written permission from the account owner to manage the assets in the best possible manner seemed a bit pointless.

[54] Flaherty.

[55] Leland, Lind-Waldock, TSA, and ICI. Carr commented that the requirement to identify the orders as part of an intermarket strategy undermined the proprietary nature and confidentiality of a trader's strategy. Morgan Stanley stated that the FCM would not be in a position to determine whether orders were in fact intermarket orders.

[56] ICI expressed concern regarding the standards by which impracticability would be judged. It recommended elimination of this component of the certification requirement.

[57] Dean Witter, Lind-Waldock, TSA, FIA, ICI, CBT, and CME. Bear Sterns also stated that providing such information to the FCM might be a breach of the account manager's fiduciary duty. Pacific stated that it would breach customer confidence to share such information with FCMs. Goldman Sachs stated that, for reasons of confidentiality, account managers may not be willing to provide FCMs with the identification of securities accounts under their management. NFA commented that the burden imposed and the privacy concerns which may be raised outweighed the minimal benefit to be derived from requiring the account manager to provide the FCM with a list of related securities accounts.

[58] Credit Agricole, Dean Witter, Refco, and FIA. Goldman Sachs also stated that, even with the information, the FCM would be unable to make any meaningful assessment regarding the nature of the order. In addition, in some instances, such as overlay programs, the account manager might not have the ability to provide information because he or she may not control the accounts.

[59] Bear Sterns, Merrill Lynch, Pacific, PaineWebber, FIA, CBT, and CME.

[60] Where the account manager places orders directly with a floor broker rather than an executing FCM, the certification need only be filed with each FCM allocating any part of an eligible order and not with the floor broker.

[61] Pursuant to Regulation 166.3, an account manager's employer, if registered with the Commission, has a duty diligently to supervise his or her activities. Regardless of registration status, a principal could be held liable for an account manager's wrongdoing under Section 2(a)(1)(A) of the Act.

[62] Where applicable, the account manager's employing firm should be aware that an account manager has the client's consent to place eligible orders.

The Commission believed that these allocation requirements, in combination with the requirement that the account manager, the FCM, and their affiliates and related parties not have any interest in any participating account or related securities account, would limit the potential for self-dealing by the account manager and the FCM. It would also provide an audit trail reflecting the ultimate disposition of the order. Further, these requirements would be consistent with good business practice.

When the order was placed, it would have to be identified as an intermarket order. The exchange would have to assure that the order was specially identified on the trade register and other computerized trade practice surveillance records. The account manager would have to provide allocation instructions for the entire order to the FCM prior to the deadline for final submission of trade data to clearing on the day the intermarket order was executed. Finally, the FCM would have to assure that the entire order was allocated to eligible customer accounts previously identified by the account manager.

2. Comments Received

The CME and CBT stated that the proposed requirement that intermarket orders must be so designated at the time of entry was inappropriate because it could reveal proprietary information and would impose a costly regulatory burden.[63] One commenter opposed the proposed requirement that these orders be identified on contract market trade registers and other records.[64] Three commenters, while agreeing that allocations should occur by the end of the day, stated that the exchange, and not the Commission, should decide the trade submission deadlines.[65] Finally, several commenters expressed concern about holding the FCM responsible for assuring that orders are allocated to eligible customer accounts.[66]

3. Reproposed Regulation 1.35(a-1)(5)(v)

After consideration of the comments received, the Commission has determined to modify certain of the allocation requirements and to add one requirement. In addition, the Commission has reorganized this paragraph to include some of the originally proposed allocation requirements as recordkeeping requirements.

The requirement that eligible orders must be so identified on the order at time of entry has been redesignated as a recordkeeping requirement. The Commission currently is proposing that each eligible order, as well as the account manager placing that order, be identified on the office order ticket, if applicable, and on the floor order ticket at the time of order placement. The Commission believes that the maintenance of a complete audit trail requires that eligible orders be properly identified from order placement through order allocation. The office and/or floor order ticket is the first step in this process.

Identification of this kind would not appear to reveal any proprietary or trading strategy information. The executing and/or allocating FCM would not need to know the specifics of the other instruments in the portfolio. Moreover, the only accounts identified to an FCM would be those to which that FCM would be allocating fills either directly or through give-ups. Rather than identifying a trading strategy, the designator would only identify an eligible order that would be allocated pursuant to these procedures. The requirement that each transaction resulting from the execution of an eligible order be identified on contract market trade registers and other computerized trade practice surveillance records remains substantially unchanged. It is simply redesignated as a recordkeeping requirement.

The reproposal would require that allocation of an eligible order must take place prior to the end of the day the order is executed, as specified by exchange rules for this purpose. Because this paragraph would also require that the account manager and the FCM allocating the order allocate fills to eligible participating customer accounts, the Commission is deleting as redundant the proposed separate paragraph that required that the FCM do so.[67]

The Commission agrees that the account manager has the responsibility for employing a system that results in fair, equitable, and non-preferential allocations. As noted below, the account manager must, upon request, provide to the Commission or the Department of Justice records that, among other things, identify the trading strategy and demonstrate the fairness of the allocations. The FCM's allocation responsibilities generally should be limited to complying with instructions from the account manager. However, as previously noted, the account manager is required to provide the FCM allocating the order with a list of eligible accounts. If the FCM were directed to allocate eligible orders to accounts not included on the list, or if the FCM should become aware of what appear to be preferential allocations, the FCM is required to make a reasonable inquiry and, if appropriate, to refer the matter to a regulatory authority (i.e., the Commission, the NFA, or its designated self regulatory organization). In addition, the FCM must act consistently with its obligations under Regulation 166.3 diligently to supervise the handling of its customer accounts.

Finally, the Commission is proposing to add a new paragraph to the allocation requirements. Specifically, the Commission is proposing a requirement that allocations made pursuant to these procedures must be fair and non-preferential, taking into account the effect on each relevant portfolio in the bunched order.

F. Recordkeeping

1. Proposed Regulation 1.35(a-1)(6)(vi)

Proposed Regulation 1.35(a-1)(6)(vi) required the following:

(1) Each account manager must make available, upon request of the Commission or the United States Department of Justice, the records referred to in paragraph (iv) of the regulation and other records, including records of securities transactions, reflecting order placement and allocation to the participating customer accounts. These records must demonstrate the relationship between the futures and the other transactions, the allocations made, the basis for allocation, and the nature of the

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[63] CBT also stated that no such requirement existed for securities transactions and that the requirement ignored the fact that the account manager was already under an existing regulatory scheme that imposed fiduciary duties. As previously noted, Carr commented that requiring that such orders be designated as part of an intermarket strategy undermines the proprietary nature and confidentiality of a trader's strategy.

[64] CBT stated that the requirement would lead to a costly regulatory burden and should be eliminated.

[65] FIA, CBT, and CME.

[66] Merrill Lynch. First Boston stated that imposing this requirement on the FCM failed to recognize that the FCM acts for the account manager and that it should be the account manager's responsibility to document and to use a fair and equitable allocation system. CBT stated that the FCM's allocation responsibilities should be limited to making allocations in accordance with the account manager's instructions and in a timely manner. Commenting on the proposed regulation generally, FIA stated that its focus should be to enable account managers the maximum latitude in placing trades subject to a fair, equitable and demonstrable allocation scheme, while recognizing that FCMs have no practical ability to supervise independent account controllers.

[67] When a trade is allocated to a specific eligible account, it belongs to that account and cannot be reallocated to any other eligible account. *In re Collins*, CFTC Docket No. 94–13, Slip op. at 11–15 (CFTC Dec. 10, 1997).

intermarket strategy. They should also permit reviewers to compare results obtained for different customers.

(2) Each account manager shall make available for review, upon request of an eligible customer, documentation sufficient for the customer to compare its results with those of other customers. The other accounts for which intermarket orders are entered may be designated by symbols so that the identity of account holders is not disclosed.

(3) Upon request, each FCM allocating intermarket orders at the direction of an account manager will exercise its best efforts to obtain from the account manager and to provide to the Commission or the Department of Justice records reflecting the related transactions in the securities accounts.

In order that any allegation of misallocation or unfavorable treatment could be properly investigated, the Commission believed that the account manager should have been required to retain and to make available for review, upon request of the Commission or the Department of Justice, the investment management rationale for intermarket orders and allocations. In order to enhance customer protection and to simplify customer account review, the Commission believed that the account manager should have been required to make available for review, upon request of a customer, documentation sufficient for that customer to compare its results with those of other customers. The identity of other account holders for which intermarket orders were entered need not, however, have been disclosed to another customer.

Finally, the Commission believed that the FCM allocating intermarket orders at the direction of an account manager should have been required, upon request of certain government agencies, to exercise its best efforts to obtain records reflecting the related transactions in the securities accounts. The determination that preferential allocation occurred could be accomplished only when all related transactions were examined and allocations in all markets were compared.[68]

2. Comments Received

Numerous commenters described the proposed recordkeeping requirements as burdensome,[69] unnecessary,[70] or unreasonable.[71] Commenters addressing the proposed requirement to make documentation available to the customer to allow that customer to compare its results with those of other customers focussed both on the possible disclosure of proprietary or confidential information [72] and on the limited value of such information to the customer.[73] All commenters who addressed the issue opposed the proposed requirement that the FCM exercise its best efforts to obtain records reflecting securities transactions from the account manager.[74]

3. Reproposed Regulation 1.35 (a–1)(5)(vi)

After consideration of the comments, the Commission has determined to modify the recordkeeping requirements originally proposed. As noted above, two items formerly identified as allocation requirements have been redesignated as recordkeeping requirements. Additionally, the Commission is proposing to add the requirement that the FCM carrying an eligible account to which an eligible order has been allocated must identify each trade resulting from the execution of an eligible order on confirmation statements provided to the affected account owner and/or trustee. The Commission believes that the account owner should be informed of all aspects of transactions executed for his or her account in order to make informed decisions about the continued use of the eligible order procedures. The Commission is deleting the requirement that, upon request, the FCM allocating eligible orders exercise its best efforts to obtain documentation from the account manager. This requirement is unnecessary since the account manager already is required to provide such documentation directly to the Commission or the Department of Justice if requested.

The Commission proposes to streamline the documentation that would be required to be made available to the Commission or the Department of Justice by the account manager. In addition to documentation reflecting customer consent to the placement and allocation of eligible orders, the account manager would be required to make available records reflecting (i) futures and option transactions,[75] (ii) other transactions executed pursuant to the portfolio management strategy, and (iii) any other records that identify the strategy and relate to, or reflect upon, the fairness of the allocations. Thus, the reproposal does not identify with the same specificity the records required to be provided. Nonetheless, the account manager would have the responsibility to demonstrate, when records are requested or during regulatory authority audits, that allocations were made fairly.

The Commission continues to believe that eligible customers should be able to compare results to other customers with similar accounts and investment strategies. Thus, the reproposal would require that the account manager make available, upon request of an eligible customer, data sufficient for that customer to compare its results with those of other relevant customers. In addition, the account manager must indicate in which of the other relevant customers it or the FCM has an interest. The Commission believes that describing the requirement in these terms permits the use of established methods used by sophisticated institutional investors in securities to measure and to compare performance. Data enabling the customer to perform such a comparison may be prepared so

[68] Based upon discussions with participants in the industry, the Commission believed that the documents, worksheets and computer programs that determined the allocation formula already were created and retained by account managers responsible for allocation decisions.

[69] Credit Agricole, Goldman Sachs, Pacific, Refco, Saul Stone, and NFA.

[70] Goldman Sachs, Morgan Stanley, TSA, MFA, and NFA. CBT commented that the value of the recordkeeping requirements appeared to be minimal.

[71] Dean Witter and Lind-Waldock. CME commented that it was overreaching for the Commission to impose recordkeeping requirements on investment advisers that are otherwise regulated.

[72] Flaherty, First Boston, Carr, N.Y. Bar, and CBT. Carr commented that it doubted customers would authorize their account manager to release details of their trading activity in order for another managed account to verify the fairness of its allocations. The N.Y. Bar stated that it believed that many customers would object to such disclosure, even in the absence of the customer's identity. According to the N.Y. Bar, activity in a particular account could provide information which would serve to identify a particular customer, and even if the identity were shielded, customers and advisers may object to the release of information which would reveal market strategies.

[73] Pacific, CBT, and CME. Flaherty commented that the proposed requirement should be modified to data, rather than documentation, sufficient for the customer to compare its overall results with those of other customers. Flaherty also suggested that eligible customers be required to acknowledge in writing that they have been informed of their right to request information on comparative results.

[74] First Boston, Goldman Sachs, Carr, Merrill Lynch, Morgan Stanley, Pacific, FIA, NFA, N.Y. Bar, CBT, and CME. According to Flaherty, such a requirement would give FCMs substantial leverage for obtaining proprietary data of the account manager and its clients, would result in account managers switching to FCMs without securities operations, and would be unnecessary because the same data could be obtained directly from the account manager by the Commission or the Department of Justice.

[75] The account manager must create and retain a record reflecting the participation of all accounts in each eligible order, including the allocation of all fills.

as not to disclose the identity of individual account holders.

G. Contract Market Rule Enforcement Programs

1. Proposed Regulation 1.35(a–1)(6)(vii)

Proposed Regulation 1.35(a–1)(6)(vii) required that, as part of its rule enforcement program, each contract market that adopted rules allowing the placement of intermarket orders would have to assure that all fills resulting from these orders were identified on contract market trade registers and other computerized trade practice surveillance records. Each contract market, or the designated self-regulatory organization (''DSRO'') of a member firm, would have to adopt an audit procedure to determine compliance with the following components of the regulation: recordkeeping requirements in paragraph (iv), account certification in paragraph (v), and allocation requirements in paragraph (vi).

The Commission believed that this surveillance was necessary to deter possible unlawful activity and to ensure that an adequate audit trail existed for intermarket transactions. As part of its routine oversight of member firms, the exchange would have been required to assure that intermarket orders were correctly identified on exchange trade registers. The exchange or the DSRO would have been required to audit member firms to assure that (i) the order was allocated prior to the deadline for final submission of trade data to clearing on the day the intermarket order was executed; (ii) the order was allocated only to eligible participating institutional customer accounts whose owners had consented to the allocation; and (iii) the FCM received and retained required documents from the account managers.

2. Comments Received

CME and CBT commented adversely on the audit procedures proposed to be imposed on exchanges. Both exchanges asserted that costs would be high and the benefit to market users would be minimal.

3. Reproposed Regulation 1.35(a–1)(5)(vii)

The requirement that the contract market assure that all fills resulting from eligible orders are identified on trade registers and other computerized trade practice surveillance records is being retained as a proposed recordkeeping requirement. Therefore, it is being deleted from this paragraph as redundant. The remainder of this paragraph is substantially consistent with the paragraph originally proposed. The contract market must adopt audit procedures to determine compliance with the identified provisions of the reproposed regulation. Specifically, these provisions would include (i) the certification requirements; (ii) the requirement that orders must be allocated to eligible accounts by the end of the day; and (iii) the requirement that eligible orders must be so identified on trade registers, other surveillance records, order tickets, and customer confirmation statements. The Commission continues to believe that these requirements are necessary to deter possible unlawful activity and to ensure that an adequate audit trail is created for eligible transactions.

III. Conclusion

The Commission is proposing, subject to certain core regulatory protections, to permit a limited number of regulated account managers to place orders for a defined group of eligible customers without providing specific customer account identifiers at the time of order placement.[76] The Commission previously has identified all of these customers as eligible to enter swap agreements or execute Section 4(c) contract market transactions. The account managers would be required to allocate the order at the end of the day.[77] As discussed below, in addition to the customer safeguards being reproposed, significant existing audit trail and recordkeeping requirements would remain applicable.

Under the reproposal, the customer must consent in advance, in writing, that orders may be placed, executed, and allocated as eligible orders. Allocations of eligible orders must be fair and non-preferential, taking into account the effect on the relevant portfolio of each customer in the bunched order. The account managers would be required to maintain records that would, among other things, reflect the portfolio management strategy and demonstrate the fairness of the allocations. These records would be available, upon request, to the Commission or the Department of Justice. The account manager would be required to provide the customer, upon request, with data sufficient to compare results with those of other relevant customers.

The reproposal prohibits an account manager and his or her partners, officers, employees, and related parties and affiliates from having an interest of ten percent or more in any account to which he or she is allocating orders. This prohibition should diminish the incentive to make preferential allocations for personal gain. Because, in some instances, the FCM may be able to influence the fairness of the allocations, the same restriction would apply to the FCM allocating the order and its partners, officers, employees, and related parties and affiliates. In addition, the reproposed recordkeeping requirements would deter and facilitate detection of misallocations which may indirectly benefit the account manager.[78] The reproposal would also require that an exchange that permits the placement, execution, and allocation of eligible orders must adopt, as part of its rule enforcement program, audit procedures to determine compliance with relevant provisions.

Under the reproposal, an eligible order must be identified at time of placement on the floor order ticket and, if appropriate, on the office order ticket. The identity of the account manager must also be included on the order tickets. All trades resulting from the execution of an eligible order must be identified on exchange trade registers and computerized trade practice

[76] The Commission believes that these core regulatory protections adequately address the issues raised by those who submitted comments opposed to either the proposed amendment to CME Rule 536 or the Commission's proposed amendment to Regulation 1.35.

The Commission appreciates the views of the law enforcement authorities which commented on the previous proposed regulation and shares their desire that Commission-regulated futures and option markets not be used as a vehicle to commit serious financial crimes. It is with those concerns in mind that the Commission has crafted the protections incorporated into the reproposed regulation. These protections include specific eligibility requirements for account managers and customers and recordkeeping provisions intended to document fair and non-preferential treatment of customers. Coupled with the strong antifraud provisions of the Act and the Commission's rigorous supervision rule, these protections should insure that the proposed allocation procedure will not unduly threaten customer protection or market integrity. Rather, the rule should enable portfolio managers acting in a fiduciary capacity to handle customer interests across markets, without undermining any legitimate customer or law enforcement interests.

[77] End-of-day or post-trade allocation of bunched or block orders is permissible on foreign futures exchanges and in the cash and securities markets. The New York Stock Exchange (''NYSE''), for example, has permitted end-of-day allocation of securities block orders since October 1983. Interpretation 88–3 of NYSE Rule 410(a)(3).

[78] As a matter of state law and federal securities, commodities, or banking law, eligible account managers would have fiduciary responsibility for their investment management activities. Additionally, account managers would be subject to Section 4b, the general antifraud provision of the Act. Account managers who are also acting as commodity trading advisors or commodity pool operators, irrespective of registration status, would also be subject to Section 4o. The securities anti-fraud rules may also apply.

surveillance records. Finally, these trades must also be identified on confirmation statements provided to the customer accounts.

Those requirements, in conjunction with existing audit trail requirements, should enable the Commission and self-regulatory organizations to track any eligible order from time of placement to allocation of fills. At time of placement, the order would be identified on order tickets. These order tickets would be timestamped upon receipt of the order. The order executions would be identified on exchange trade registers by, among other things, both time and price. The order tickets would be timestamped again to identify time of report of execution. The trading cards and/or order tickets would reflect the terms of the order executions. The subsequent allocation of the fills would be maintained on FCM and exchange records. Where it is the exchange's practice to do so, the allocation of the fills to specific customer accounts would be reflected on the exchange's final trade register. The order would be identified on confirmation statements sent to the owner of the account. Thus, an auditor could determine, among other things, the size and time of initial order placement, the times and prices of executions, the identities of accounts to which the fills were allocated, and the prices and quantities of the fills allocated thereto.

The Commission encourages commenters to address the appropriateness of the balance being struck by this reproposal between protection of sophisticated market participants and regulatory reform. Additionally, the Commission encourages commenters to address the proposition that the relief being proposed herein, through an amendment to the Commission's recordkeeping requirements, might be achievable to some extent through enhanced customer disclosure and reliance on the account managers' fiduciary responsibility.

IV. Other Matters

A. Regulatory Flexibility Act

The Regulatory Flexibility Act (''RFA''), 5 U.S.C. 601 *et. seq.*, requires that agencies, in proposing rules, consider the impact of those rules on small businesses. The Commission has previously determined that contract markets,[79] futures commission merchants,[80] registered commodity pool operators,[81] and large traders[82] are not ''small entities'' for purposes of the Regulatory Flexibility Act. The Commission has previously determined to evaluate within the context of a particular rule proposal whether all or some commodity trading advisors should be considered ''small entities'' for purposes of the Regulatory Flexibility Act and, if so, to analyze the economic impact on commodity trading advisors of any such rule at that time.[83] Commodity trading advisors who would place eligible orders pursuant to these procedures would do so for multiple clients and would be participating as investment managers in more than one financial market. Accordingly, the Commission does not believe that commodity trading advisers should be considered ''small entities'' for purposes of this regulation.

Therefore, the Chairperson, on behalf of the Commission, hereby certifies, pursuant to 5 U.S.C. 605(b), that the action proposed to be taken herein will not have a significant economic impact on a substantial number of small entities.

Proposed Regulation 1.35(a–1)(5) generally would apply to large users of the market. It would provide relief from individual account identification requirements, thereby providing those small entities who elect to use the relief with a less burdensome method for satisfying Commission Regulation 1.35 requirements.

B. Paperwork Reduction Act

When publishing proposed rules, the Paperwork Reduction Act of 1995 (Pub. L. 104–13 (May 13, 1995)) imposes certain requirements on federal agencies (including the Commission) in connection with their conducting or sponsoring any collection of information as defined by the Paperwork Reduction Act. In compliance with the Act, the Commission, through this rule proposal, solicits comments to:

(1) evaluate whether the proposed collection of information is necessary for the proper performance of the functions of the agency, including the validity of the methodology and assumptions used; (2) evaluate the accuracy of the agency's estimate of the burden of the proposed collection of information, including the validity of the methodology and assumptions used; (3) enhance the quality, utility, and clarity of the information to be collected; and (4) minimize the burden of the collection of information on those who are to respond, including through the use of appropriate automated, electronic, mechanical, or other technological collection techniques or other forms of information technology, *e.g.*, permitting electronic submission of responses.

The Commission has submitted this proposed rule and its associated information collection requirements to the Office of Management and Budget. The burden associated with this entire collection (3038–0022), including this proposed rule, is as follows:

Average burden hours per response: 3547.01.

Number of Respondents: 11,011.00.

Frequency of Response: On Occasion.

The burden associated with this specific proposed rule is as follows:

Average burden hours per response: 0.75.

Number of Respondents: 400.00.

Frequency of Response: On Occasion.

Persons wishing to comment on the information which would be required by this proposed rule should contact the Desk Officer, CFTC, Office of Management and Budget, Room 10202, NEOB, Washington, DC 20503, (202) 395–7340. Copies of the information collection submission to OMB are available from the CFTC Clearance Officer, 1155 21st Street, NW, Washington, DC 20581, (202) 418–5160.

List of Subjects in 17 CFR Part 1

Brokers, Commodity futures, Commodity options, Consumer protection, Contract markets, Customers, Members of contract markets, Noncompetitive trading, Reporting and recordkeeping requirements, Rule enforcement programs.

In consideration of the foregoing, and pursuant to the authority contained in the Commodity Exchange Act and, in particular, Sections 5, 5a, 5b, 6(a), 6b, 8a(7), 8a(9) and 8c, 7 U.S.C. 7, 7a, 7b, 8(a), 8b, 12a(7), 12a(9), and 12c, the Commission hereby proposes to amend Part 1 of Chapter I of Title 17 of the Code of Federal Regulations as follows:

PART 1—GENERAL REGULATIONS UNDER THE COMMODITY EXCHANGE ACT

1. The authority citation for Part 1 continues to read as follows:

Authority: 7 U.S.C. 1a, 2, 2a, 4, 4a, 6, 6a, 6b, 6c, 6d, 6e, 6f, 6g, 6h, 6i, 6j, 6k, 6l, 6m, 6n, 6o, 6p, 7, 7a, 7b, 8, 9, 12, 12a, 12c, 13a, 13a–1, 16, 16a, 19, 21, 23 and 24.

2. Section 1.35 is proposed to be amended by revising paragraphs (a–1)(1), (2)(i), and (4) and by adding paragraph (a–1)(5) to read as follows:

[79] 47 FR 18618, 18619 (April 30, 1982).

[80] *Id.*

[81] *Id.* at 18620.

[82] *Id.*

[83] *Id.*

§ 1.35 Records of Cash Commodity, Futures, and Option Transactions

* * * * *

(a–1) * * *

(1) Each futures commission merchant and each introducing broker receiving a customer's or option customer's order shall immediately upon receipt thereof prepare a written record of the order including the account identification, except as provided in paragraph (a–1)(5) of this section, and order number, and shall record thereon, by timestamp or other timing device, the date and time, to the nearest minute, the order is received, and in addition, for option customers' orders, the time, to the nearest minute, the order is transmitted for execution.

(2)(i) Each member of a contract market who on the floor of such contract market receives a customer's or option customer's order which is not in the form of a written record including the account identification, order number, and the date and time, to the nearest minute, the order was transmitted or received on the floor of such contract market, shall immediately upon receipt thereof prepare a written record of the order in nonerasable ink, including the account identification, except as provided in paragraph (a–1)(5) of this section or appendix C to this part, and order number and shall record thereon, by timestamp or other timing device, the date and time, to the nearest minute, the order is received.

* * * * *

(4) Each member of a contract market reporting the execution from the floor of the contract market of a customer's or option customer's order or the order of another member of the contract market received in accordance with paragraphs (a–1)(2)(i) or (a–1)(2)(ii)(A) of this section, shall record on a written record of the order, including the account identification, except as provided in paragraph (a–1)(5) of this section, and order number, by timestamp or other timing device, the date and time to the nearest minute such report of execution is made. Each member of a contract market shall submit the written records of customer orders or orders from other contract market members to contract market personnel or to the clearing member responsible for the collection of orders prepared pursuant to this paragraph as required by contract market rules adopted in accordance with paragraph (j)(1) of this section. The execution price and other information reported on such order tickets must be written in nonerasable ink.

(5) *Bunched orders for eligible accounts.* A specific customer's account identifier need not be recorded at the time a bunched order is placed on a contract market or upon report of execution, provided that the following requirements are met and that the order is handled in accordance with contract market rules that have been submitted to the Commission and approved or permitted into effect pursuant to Section 5a(a)(12)(A) of the Act and § 1.41. The bunched order must be allocated to the eligible accounts prior to the end of the day on which the order is executed.

(i) Eligible orders. Bunched orders placed, executed, and allocated pursuant to this paragraph (a-1)(5) must be placed by an eligible account manager on behalf of consenting eligible customers as part of its management of a portfolio also containing instruments which are either exempt from regulation pursuant to the Commission's regulations or excluded from Commission regulation under the Act.

(ii) Eligible account managers. The person placing and/or directing the allocation of an eligible order and its principal, if any, (''account manager'') must be one of the following which has been granted investment discretion with regard to eligible customer accounts:

(A) A commodity trading advisor registered with the Commission pursuant to the Act;

(B) An investment adviser registered with the Securities and Exchange Commission pursuant to the Investment Advisers Act of 1940; or

(C) A bank, insurance company, trust company, or savings and loan association subject to federal or state regulation.

(iii)Eligible customers.

(A) Eligible orders may be allocated to accounts owned by the following entities which have consented in advance, in writing, to the account manager that orders may be placed, executed, and allocated in accordance with this paragraph:

(*1*) A bank or trust company;

(*2*) A savings association or credit union;

(*3*) An insurance company;

(*4*) An investment company subject to regulation under the Investment Company Act of 1940 (15 U.S.C. 80a–1, *et seq.*) or an investment company performing a similar role or function subject to foreign regulation, provided that the investment company or foreign person is not formed solely for the purpose of constituting an eligible customer and has total assets exceeding $5,000,000;

(*5*) A commodity pool formed and operated by a person subject to regulation under the Act or a foreign person performing a similar role or function subject to foreign regulation, provided that the commodity pool or foreign person is not formed solely for the purpose of constituting an eligible customer and has total assets exceeding $5,000,000;

(*6*) A corporation, partnership, proprietorship (but not a sole proprietorship), organization, trust, or other entity comprised of more than one person, provided that the entity was not formed solely for the purpose of constituting an eligible customer and has either a net worth exceeding $1,000,000 or total assets exceeding $10,000,000;

(*7*) A corporate qualified pension, profit sharing, or stock bonus plan subject to Title 1 of the Employee Retirement Income Security Act of 1974 (''ERISA''), or a foreign person performing a similar role or function subject to foreign regulation, with total assets exceeding $5,000,000 or whose investment decisions are made by a bank, trust company, insurance company, investment adviser subject to regulation under the Investment Advisers Act of 1940 (15 U.S.C. 80b–1, *et seq.*), or a commodity trading advisor subject to regulation under the Act, or any plan defined as a governmental plan in Section 3(32) of Title 1 of ERISA, but not including a self-directed plan;

(*8*) Any governmental entity (including the United States, any state, or any foreign government) or political subdivision thereof, or any multinational or supranational entity or any instrumentality, agency, or department of any of the foregoing;

(*9*) A broker-dealer subject to regulation under the Securities Exchange Act of 1934 (15 U.S.C. 78a, *et seq.*) or a foreign person performing a similar role or function subject to foreign regulation, acting on its own behalf; provided, however, that the broker-dealer may not be a natural person or sole proprietorship; or

(*10*) A futures commission merchant subject to regulation under the Act or a foreign person performing a similar role or function subject to foreign regulation, acting on its own behalf; provided, however, that the futures commission merchant may not be a natural person or sole proprietorship.

(B) The following persons, or any combination thereof, may not have an interest of ten percent or greater in any account that receives any part of an eligible order:

(*1*) The account manager;

(*2*) The futures commission merchant allocating the order;

(*3*) Any general partner, officer, director, or owner of ten percent or more of the equity interest in the

account manager or the futures commission merchant allocating the order;

(*4*) Any employee, associated person, or limited partner of the account manager or the futures commission merchant allocating the order who affects or supervises the handling of the order;

(*5*) Any business affiliate that, directly or indirectly, controls, is controlled by, or is under common control with, the account manager or the futures commission merchant allocating the order; or

(*6*) Any spouse, parent, sibling, or child of the foregoing persons.

(iv) Account certification.

(A) Before placing the initial eligible order, the account manager must certify, in writing, to each futures commission merchant executing and/or allocating any part of the order that the account manager is aware of the provisions of this paragraph and is, and will remain, in compliance with the requirements of this paragraph.

(B) Before placing the initial eligible order, the account manager must provide each futures commission merchant allocating the order with a list of eligible futures accounts.

(v) Allocation.

(A) The account manager and the futures commission merchant allocating the order must allocate fills from each eligible order to eligible participating customer accounts prior to the end of the day the order is executed, as specified by exchange rules for this purpose.

(B) Allocations of eligible orders must be fair and non-preferential, taking into account the effect on each relevant portfolio in the bunched order.

(vi) Recordkeeping.

(A) Each eligible order must be identified on the office and floor order tickets at the time of placement. These order tickets also must identify the account manager placing the order.

(B) Each transaction resulting from an eligible order must be identified on contract market trade registers and other computerized trade practice surveillance records.

(C) The futures commission merchant carrying the account must identify each trade resulting from the execution of an eligible order on confirmation statements provided to eligible customer accounts.

(D) Each account manager must make available, upon request of any representative of the Commission or the United States Department of Justice, the following:

(*1*) The customer consent documents required pursuant to paragraph (a-1)(5)(iii)(A) of this section; and

(*2*) Records reflecting futures and option transactions, other transactions executed pursuant to the portfolio management strategy, and any other records that would identify the management strategy and relate to, or reflect upon, the fairness of the allocations.

(E) Each account manager must make available for review, upon request of an eligible customer, data sufficient for that customer to compare its results with those of other relevant customers. These data may be prepared so as not to disclose the identity of individual account holders.

(vii) Contract market rule enforcement programs. As part of its rule enforcement program, each contract market that adopts rules that allow the placement, execution, and allocation of eligible orders must adopt audit procedures to determine compliance with the certification, allocation, and recordkeeping requirements identified in paragraphs (a-1)(5)(iv), (v)(A), and (vi)(A) through (C) of this section.

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Issued in Washington, DC on December 31, 1997 by the Commission.

Catherine D. Dixon,

Assistant Secretary of the Commission.

[FR Doc. 98–240 Filed 1–6–98; 8:45 am]

BILLING CODE 6351–01–P

DEPARTMENT OF THE TREASURY

Internal Revenue Service

26 CFR Part 1

[REG–119449–97]

RIN 1545–AV75

Qualified Zone Academy Bonds

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Notice of proposed rulemaking by cross-reference to temporary regulations and notice of public hearing.

SUMMARY: In the Rules and Regulations section of this issue of the **Federal Register**, the IRS is issuing temporary regulations that provide guidance to holders and issuers of qualified zone academy bonds. These proposed regulations reflect changes made by the Taxpayer Relief Act of 1997, Pub. L. No. 105–34, 111 Stat. 788 (1997), and affect holders and issuers of qualified zone academy bonds. The text of those temporary regulations also serves as the text of these proposed regulations. This document also provides a notice of public hearing on these proposed regulations.

DATES: Written comments must be received by April 7, 1998. Outlines of topics to be discussed at the public hearing scheduled for May 27, 1998, must be received by May 6, 1998.

ADDRESSES: Send submissions to CC:DOM:CORP:R (REG–119449–97), room 5226, Internal Revenue Service, POB 7604, Ben Franklin Station, Washington, DC 20044. Submissions may be hand delivered between the hours of 8 a.m. and 5 p.m. to: CC:DOM:CORP:R (REG–119449–97), Courier's Desk, Internal Revenue Building, 1111 Constitution Avenue NW, Washington, DC. Alternatively, taxpayers may submit comments electronically via the Internet by selecting the ''Tax Regs'' option on the IRS Home Page, or by submitting directly to the IRS Internet site at http:www.irs.ustreas.gov/prod/taxregs/comments.html. The public hearing will be held in Room 2615, Internal Revenue Building, 1111 Constitution Ave. NW, Washington, DC.

FOR FURTHER INFORMATION CONTACT: Concerning the regulations, Timothy L. Jones, (202) 622–3980; concerning submissions and the hearing, LaNita Van Dyke (202) 622–7180 (not toll-free numbers).

SUPPLEMENTARY INFORMATION:

Background

Section 1.1397E–1T, published in the Rules and Regulations portion of this issue of the **Federal Register**, is issued to provide guidance to holders and issuers of qualified zone academy bonds.

The text of those temporary regulations also serves as the text of these proposed regulations. The preamble to the temporary regulations explains the temporary regulations.

Special Analyses

It has been determined that this notice of proposed rulemaking is not a significant regulatory action as defined in EO 12866. Therefore, a regulatory assessment is not required. It has also been determined that section 553(b) of the Administrative Procedure Act (5 U.S.C. chapter 5) does not apply to these regulations, and, because the regulations do not impose a collection of information on small entities, the Regulatory Flexibility Act (5 U.S.C. chapter 6) does not apply. Pursuant to section 7805(f) of the Internal Revenue Code, this notice of proposed rulemaking will be submitted to the Chief Counsel for Advocacy of the Small