

managers and FCMs. Proposed Rule 1.35(a-1)(5)(iii) would explicitly state that allocation of bunched orders must be made by account managers, not FCMs. Eliminating the certification requirements will reduce the administrative and recordkeeping burden on FCMs. Of course, FCMs will still have responsibility to monitor for unusual account activity. In an interpretive notice accompanying NFA Compliance Rule 2-10, NFA notes "[t]he FCM has certain basic duties to its customers, including the duty to supervise its own activities in a way designed to ensure that it treats its customers fairly. Specifically, the FCM would violate this duty if it has actual or constructive notice that allocations for its customers may be fraudulent and fails to take appropriate action. The FCM with such notice must make a reasonable inquiry into the matter and, if appropriate, refer the matter to the proper regulatory authorities."¹⁴ Thus, FCMs will have an ongoing responsibility to monitor for unusual account activity.¹⁵

The Commission requests comment on whether the proposed changes strike the appropriate balance with regard to judging allocations and assigning responsibilities to account managers and FCMs.

F. Recordkeeping

Current Rule 1.35(a-1)(5)(vi) requires account managers and FCMs to keep specific information to identify customer orders and reconstruct trades. Pursuant to the proposed rule, the Commission is clarifying that the fairness of an allocation will not be assessed on an order-by-order basis but on an assessment over time. If divergent performance among client accounts occurs over time, the account manager must have records to demonstrate that the divergent performance is attributable to factors other than unfair trade allocation. Thus, the proposed rule will allow account managers and FCMs greater flexibility in recordkeeping, while retaining the

ability of the Commission to determine unfair trade allocation.

Specifically, the Commission proposes to eliminate existing Rule 1.35(a-1)(5)(vi) and to replace the recordkeeping requirement with a requirement that account managers make certain information available to any representative of the Commission, the United States Department of Justice, or other appropriate regulatory agency. The information would include the information required to be made available to customers pursuant to proposed Rule 1.35(a-1)(5)(ii) and the allocation information created pursuant to proposed Rule 1.35(a-1)(5)(iii). Under proposed Rule 1.35(a-1)(5)(iv)(C), FCMs that execute trades for orders eligible for post-execution allocation, or that carry accounts to which contracts executed for such orders are allocated, must maintain records that identify each order subject to post-execution allocation and the accounts to which contracts executed for such order are allocated.¹⁶

For example, account managers employing post-execution allocation procedures generally would be expected to forward written allocation instructions to the clearing firm by facsimile or e-mail or other electronic means.¹⁷ In those instances in which allocation instructions are furnished orally, the FCM must create a written record of the account manager's instructions. In each case, these records will be available to the Commission and other regulatory agencies or self-regulatory organizations. The Commission should be able to reconstruct trades from these records.

The proposal contains a provision to address cases in which account managers fail to provide the Commission with the information requested pursuant to proposed Rule 1.35(a-1)(5)(iv)(A) or proposed Rule 1.35(a-1)(5)(iv)(B). Specifically, the Commission may prohibit the account manager from submitting orders for execution on designated contract markets and prohibit FCMs from accepting orders from such account managers. Commission action under this provision would not require prior notice and hearing. The failure of an account manager to respond to a request for information under this rule would be sufficient. Any account manager that believes he or she is adversely affected

by this process may use the procedures outlined in Rule 21.03(g).¹⁸ Any prohibitions imposed pursuant to this Rule 1.35(a-1)(5)(iv)(D) would be without prejudice to other remedies the Commission or other regulatory body may have against the account manager in question for violation of the rule or any other legal requirements.¹⁹

G. Self-Regulatory Organization Rule Enforcement and Audit Procedures

Existing Rule 1.35(a-1)(5)(vii) requires contract markets to adopt audit procedures to determine compliance with the certification requirements of Rule 1.35(a-1)(5)(vi). As noted above, the Commission is proposing to eliminate the recordkeeping and certification requirement and, accordingly, to eliminate Rule 1.35(a-1)(5)(vii).

Although, the Commission proposes to eliminate Rule 1.35(a-1)(5)(vii), the Commission will work with NFA to evaluate NFA's audit and examination process to identify any supervisory enhancements that will be necessary to ensure that customers are adequately protected and treated fairly.

III. Requests For Comment

The Commission has identified throughout this release issues on which it requests comment. In addition to the specific issues raised above, the Commission welcomes comment on any aspect of the proposed rule.

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,²⁰ futures commission merchants,²¹ registered commodity pool operators²² and large traders²³ 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.²⁴

¹⁴ Interpretive Notice, NFA Compliance Rule 2-10: The Allocation of Block Orders for Multiple Accounts (June 9, 1998).

¹⁵ *Id.*; see also, 17 CFR 166.3 (2002) (stating that Commission registrants have a duty to diligently supervise handling of all commodity interest accounts). FCMs also have a duty to monitor for money laundering and report such activities to the appropriate regulatory authority. Interpretive Notice, NFA Compliance Rule 2-9: FCM and IB Anti-Money Laundering Program. For example, if an adviser places bunched orders with an FCM and routinely instructs the FCM to allocate favorable trades or unfavorable trades in a bunched order to one customer account, then this could constitute unusual account activity that an FCM has a duty to investigate and if appropriate report to regulators.

¹⁶ The recordkeeping provisions of Rule 1.31 would still apply. 17 CFR 1.31 (2002).

¹⁷ It is important to note that unless the order is submitted consistent with the requirements of this proposed rule, the order must contain a customer identification number. See, 17 CFR 1.35(a-1) (2002).

¹⁸ 17 CFR 21.03(g) (2002).

¹⁹ See, 17 CFR 21.03(h) (2002).

²⁰ 47 FR 18618, 18619 (April 30, 1982).

²¹ *Id.*

²² *Id.* at 18620.

²³ *Id.*

²⁴ *Id.*