

provide written investment discretion to account managers.¹¹

In the proposal, the Commission requested comment on whether it should retain an interpretive notice currently found at Appendix C to Part 1.¹² Appendix C allows CTAs to bunch orders if they prefile their allocation procedures with a clearing member, NFA, or an exchange. As the Commission noted in the proposal, Appendix C may prove unnecessary given the amended rule. One commenter, FIA, stated that the Commission should make clear that the amended rule supercedes any NFA interpretive notices or Commission rules to the extent they are inconsistent. The Commission notes that Appendix C governs the allocation of bunched orders pursuant to a pre-filed or contemporaneously-filed allocation scheme as opposed to the amended Rule, which governs the post-execution allocation of bunched orders. However, if any conflict between the two rules arises, the standards set forth in this rule supercede any interpretive guidance on bunched orders issued by the Commission. The Commission will retain Appendix C as guidance to account managers who may wish to allocate orders under the circumstances described therein and as an example of permissible allocation methods, but may reconsider this issue in the future.

B. Eligible Account Managers

Current rule 1.35(a-1) includes as eligible account managers registered CTAs and Investment Advisers ("IAs"), banks, insurance companies, trust companies, and savings and loan associations. Rule 1.35(a-1), as amended, expands the class of account managers permitted to bunch orders.¹³ Generally, the Commission and the Securities and Exchange Commission exempt certain CTAs and IAs from registration or other regulatory requirements if they exclusively service certain sophisticated customers.¹⁴ The Commission believes that post-execution allocation should be expanded to these entities. The amended rule expands the list of

eligible account managers to include CTAs and IAs who are exempt from registration, or are excluded from the definition of CTA or IA by operation of law or rule. In addition, the amended rule allows foreign advisors, who exercise discretionary trading authority over the accounts of non-United States persons, to be eligible account managers regardless of whether the foreign advisor has been granted an exemption pursuant to Rule 30.10.¹⁵

As noted in the proposal, the amended rule does not apply to associated persons or introducing brokers exempt from Commission registration as CTAs pursuant to Rule 4.14(a)(3) and (6).¹⁶ As also noted in the proposed rule, the Commission will retain antifraud and antimanipulation authority over account managers who are exempt from registration. The Commission notes that foreign advisers would be foreign brokers or foreign traders subject to Commission Rule 15.05, which makes the FCMs through which foreign advisers make or cause to be made trades the agents of the foreign advisers for purposes of communications from the Commission.¹⁷

C. Information

The Commission has converted the disclosure requirement of Rule 1.35(a-1) to an information availability requirement. Under the amended rule, account managers are required to make the following information available to customers upon request: (1) The general nature of the allocation methodology the account manager uses; and (2) summary or composite data sufficient for that customer to compare its results with those of other relevant customers and, if applicable, any account in which the account manager has an interest. In addition, the Commission has added a requirement that account managers make available information on whether accounts in which the account manager may have any interest may be included with customer accounts in bunched

orders eligible for post-execution allocation.¹⁸

One commenter, John Henry & Company, suggested that the amended rule clarify the definition of "results" to include only the result of executions and allocations as opposed to a broader measure such as account performance results. The Commission agrees. Therefore, under the amended Rule 1.35(a-1), account managers must only make available the results of executions and allocations to comply with Rule 1.35(a-1)(5)(ii)(C).

D. Allocation

The amended rule clarifies the allocation procedures for post-execution allocation of bunched orders. In particular, the rule makes clear that the Commission will examine allocation fairness over time, rather than trade-by-trade.

The amended rule requires that account managers observe three requirements when allocating post-execution. First, pursuant to Rule 1.35(a-1)(5)(iii)(A), allocations must be fair and equitable. No account or group of accounts may receive consistently favorable or unfavorable treatment. Second, to determine whether the account manager is allocating fills fairly, the amended rule mandates that account managers use an allocation methodology sufficiently objective and specific to permit independent verification of the fairness of the allocation.¹⁹ The final rule permits the account manager to exercise discretion over the allocation methodology, recognizing that allocation strategies may need to vary in order to treat all customers fairly. However, the Commission must be able to reconstruct the allocation methodology sufficiently to verify that the account manager is acting without bias.

One commenter, Paul H. Bjarnason, Jr., expressed concern that the amended rule may allow biased allocations by unscrupulous account managers. To combat biased allocations, Mr. Bjarnason recommended that the amended rule define allocation bias and require measurement of it with an

¹¹ Rule 1.35(a-1)(5) and NFA Compliance Rule 2-8(a), require that grants of discretionary authority to account controllers be in writing.

¹² 17 CFR Part 1, Appendix C (2002), 62 FR 25470 (May 8, 1997).

¹³ In the proposal, the Commission requested comment on whether it was appropriate to expand the list of eligible account managers. All comments received on this issue supported the expansion of eligible account managers.

¹⁴ Another Commission rule proposal would expand the number of entities that are exempt from CTA registration. See, 68 FR 12622 (March 17, 2003).

¹⁵ 17 CFR 30.10 (2002). Rule 30.10 permits any person to petition for an exemption from certain of the Commission's Part 30 rules, which govern foreign futures and option trading by persons located in the United States. Commission orders issued pursuant to Rule 30.10 permit firms, among other things, to solicit and accept orders for foreign futures and option contracts from United States customers without registering under the Commodity Exchange Act, based upon substituted compliance with the rules and regulations of the jurisdiction in which the firm is located.

¹⁶ 17 CFR 4.14(a)(3) (2002), 17 CFR 4.14(a)(6) (2002).

¹⁷ See 17 CFR 15.00(e) and 17 CFR 15.05 (2002).

¹⁸ In the proposal, the Commission requested comment on whether the information availability requirement was sufficient to inform customers. All comments received on this issue supported the information availability requirement.

¹⁹ Appendix C of Part 1 contains examples of allocation methods. See, 17 CFR Part 1, Appendix C (2002), 62 FR 25470 (May 8, 1997). As noted in Appendix C, "the appropriateness of any particular method for allocating split and partial fills depends on the CTA's overall trading approach. For example, a daily rotation of accounts may satisfy the general standards for CTAs who trade on a daily basis but inappropriate for CTAs who trade less frequently."