

appropriate accounting system. In addition, Mr. Bjarnason suggested that the amended rule require account managers to track for bias in their trade allocations.

As noted above, the Commission mandates that allocations be fair and equitable. The Commission agrees that account managers should diligently monitor for bias in their trade allocations and notes that NFA, in its interpretive notices, provides guidance on the type of allocation methodologies designed to provide non-preferential treatment.²⁰ In its comment letter, NFA notes that it will amend its interpretive notices regarding bunched orders, but will retain the requirement that CTAs use an allocation methodology designed to provide non-preferential treatment for all accounts.²¹ Thus, given that NFA will be retaining this requirement, the Commission believes that it is unnecessary to modify the rule to define allocation bias further.

The third requirement that account managers must observe under the amended rule is to provide information to FCMs no later than a time sufficiently before the end of the day the order is executed to ensure that clearing records identify the ultimate customer for each trade. FIA, in its comment, noted a discrepancy in the proposing release. FIA noted that the preamble to the proposed rule stated that account managers must provide allocation information to FCMs in a time sufficiently before the end of the "trading session," although the proposed rule text stated that account managers must provide allocation information sufficiently before the end of the "trading day." In response, the Commission wishes to make clear that account managers must provide allocation information to FCMs before the end of the trading day during which the order is executed.

As noted above, the amended rule clarifies the respective responsibilities

of account managers and FCMs.²² Account managers are responsible for the allocation of bunched orders, not FCMs. Comments submitted by FCMs stated that the proposed amendments accurately reflect today's increasing use of electronic order entry systems. As Goldman Sachs noted in its comment, "[t]he wide use of give-up arrangements means that an account manager's transactions on behalf of its clients frequently are executed through one FCM and later cleared through several different FCMs * * *. An FCM, therefore may have no reason to know that an order has been executed for a client's account until the transaction has been executed and cleared."

All FCMs will continue to have responsibility to monitor for unusual account activity. As noted in the proposed release, an interpretive notice accompanying NFA Compliance Rule 2-10, states that "[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, an 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. An FCM with such notice must make a reasonable inquiry into the matter and, if appropriate, refer the matter to the proper regulatory authorities."²³

Under the amended rule, account managers have a responsibility to allocate trades fairly and equitably and FCMs must monitor account managers for unusual account activity. Paul H. Bjarnason, Jr., in his comment, expressed concern that, although account managers and FCMs have a duty to ensure that customers receive fair treatment, the amended rule may not prescribe sufficient oversight of allocations. Mr. Bjarnason suggests that account managers submit allocation reports to NFA and that NFA provide adequate audits of trade allocations. In response, as explained below, the Commission will require that account managers keep records sufficient to demonstrate that all allocations are fair and equitable and that the allocation methodology used by the account manager is objective. These records will be available to the Commission and other appropriate regulatory agencies. Customers will also have access to this

information as well. In addition, the Commission notes that NFA schedules CTA audits using a risk-based auditing system that incorporates a regular auditing cycle. In its comment, NFA stated that any complaint involving fraudulent allocations would result in an immediate examination of any account manager registered with the Commission as a CTA. Therefore, given the recordkeeping requirements of the amended rule and NFA oversight, the Commission has determined to adopt the provision as proposed.

E. Records

Amended Rule 1.35(a-1)(5)(vi) requires that account managers keep two types of records. First, account managers must keep records of information maintained pursuant to amended Rule 1.35(a-1)(5)(ii). Second, account managers must make records available that allow independent verification of the fairness of the account manager's allocation methodology as required in Rule 1.35(a-1)(5)(iii). The records kept pursuant to amended Rule 1.35(a-1)(5)(iv) must be made available to any representative of the Commission, the United States Department of Justice, or other appropriate regulatory body.

The amended rule contains a provision to address cases in which account managers fail to provide the Commission with the information requested pursuant to amended Rule 1.35(a-1)(5)(iv)(A) or (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 to trigger the prohibition. Any account manager that believes he or she is adversely affected by this process may use the procedures outlined in Rule 21.03(g).²⁴ Any prohibitions imposed pursuant to this Rule 1.35(a-1)(5)(iv)(D) would be without prejudice to any other remedies the Commission or any other regulatory body may have against the account manager in question for violation of the rule or any other legal requirements.²⁵

Two commenters, MFA and John Henry & Company, expressed concern that the proposed information request provision would be too severe. MFA

²⁰ Interpretive Notice, NFA Compliance Rule 2-10: The Allocation of Block Orders for Multiple Accounts (June 9, 1998). Not all eligible account managers, e.g., foreign account managers, will be subject to NFA requirements or inspections. However, FCMs will remain subject to the duty to supervise accounts, whether or not managed by third party account managers. See, 17 CFR 166.3 (2002). In addition, FCMs are subject to NFA's requirements.

²¹ In addition, NFA anticipates it will continue to (1) provide guidance on the type of allocation methodologies designed to provide non-preferential treatment; (2) require CTAs to regularly analyze each trading program to ensure that the allocation method has been fair and equitable and to document this analysis and (3) remind FCMs that they have certain basic duties to their customers in connection with bunched orders.

²² In the proposal, the Commission requested comment on whether the proposed rule struck the appropriate balance with regard to judging allocation and assigning responsibilities to account managers and FCMs. All comments received on this issue supported the changes.

²³ *Id.*

²⁴ 17 CFR 21.03(g) (2002).

²⁵ Cf. 17 CFR 21.03(h) (2002) (providing for other Commission remedies).