NATIONAL FUTURES ASSOCIATION
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December 7, 1995

Ms. Jean A. Webb
Secretariat
Commodity Futures Trading Commission
Three Lafayette Centre
1155 21st Street, N.W.
Washington, D.C. 20581

Re: National Futures Association: Proposed Amendment to NFA Compliance Rule 2-13, Proposed Amendment to the Guideline for the Disclosure by CPOs and CTAs of "Up Front" Fees and Organizational and Offering Expenses, and Proposed Adoption of an Interpretive Notice to NFA Compliance Rule 2-10 Relating to the Allocation of Block Orders for Multiple Accounts

Dear Ms. Webb:

Pursuant to Section 17(j) of the Commodity Exchange Act, as amended ("the Act"), National Futures Association ("NFA") hereby submits to the Commodity Futures Trading Commission ("Commission") proposed amendment to NFA Compliance Rule 2-13, proposed amendment to the Guideline for the Disclosure by CPOs and CTAs of "Up Front" Fees and Organizational and Offering Expenses, and the proposed adoption of an Interpretive Notice to NFA Compliance Rule 2-10 Relating to the Allocation of Block Orders for Multiple Accounts. The proposals contained herein were approved by NFA's Board of Directors ("Board") on November 16, 1995. NFA respectfully requests Commission review and approval of the proposals.

PROPOSED AMENDMENTS

A. Proposed Amendment to NFA Compliance Rule 2-13 (additions are underscored):

COMPLIANCE RULES

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Part 2 -- RULES GOVERNING THE BUSINESS CONDUCT OF MEMBERS REGISTERED WITH THE COMMISSION

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Rule 2-13. CPO/CTA REGULATIONS.

(a) Any Member who violates any of CFTC Regulations 4.1 and 4.16 through 4.41 shall be deemed to have violated an NFA requirement.

(b) Each Member CPO which delivers or causes to be delivered a Disclosure Document under CFTC Regulation 4.21 must include in the Disclosure Document a break-even analysis which includes a tabular presentation of fees and expenses. The break-even analysis must be presented in the manner prescribed by NFA's Board of Directors.

(c) Each Member required to file any document with or give notice to the CFTC under CFTC Regulations 4.13 and 4.16 through 4.32 shall also file one copy of such document with or give such notice to NFA at its Chicago office no later than the date such document or notice is due to be filed with or given to the CFTC. Any CPO Member may file with NFA a request for an extension of time in which to file the annual report required by CFTC Regulation 4.22(c) or a request for approval of a change to its fiscal-year election by following the procedures set forth in NFA Financial Requirements Schedule E.

(d) A Member CPO may deliver a notice of intended offering and statement of terms to prospective participants who are accredited investors, as defined in 17 C.F.R. 230.501(a), prior to the delivery of a Disclosure Document, provided that the notice of intended offering and statement of terms clearly states that the offering will be made only by means of a Disclosure Document and includes no more than the following additional information:

(1) the name of the CPO, issuer, underwriter, and selling agent;

(2) the name of the pool;

(3) the title, amount, minimum escrow, and basic terms of the equity interests the CPO proposes to offer;

(4) the anticipated time of the offering and a brief statement of the manner and purposes of the offering;

(5) the type of pool (e.g., multi-advisor, single-advisor, or principal-protected) and interests to be traded and, for a single-advisor pool, the name of the CTA;

(6) any limitations regarding who may invest in the pool or the amount of any investment;

(7) any statement or legend required by any applicable laws, regulations, or rules or by any state, federal, or foreign regulator; and

(8) the name and address and/or telephone number to write or call in order to obtain a copy of the Disclosure Document.

Unless the pool is offered under CFTC Regulation § 4.7, the CPO must provide a Disclosure Document to the accredited investor upon request or prior to accepting or receiving funds, securities, or other property from the accredited investor for the purpose of investing in the pool. A notice of intended offering and statement of terms may not be distributed by any means that is likely to reach persons who do not qualify as accredited investors under 17 C.F.R. 230.501(a).

B. Proposed Amendment to the Guideline for the Disclosure by CPOs and CTAs of "Up Front" Fees and Organizational and Offering Expenses (deletions are bracketed and additions are underscored):

Interpretation of NFA Compliance Rule 2-13: Guideline for the Disclosure by CPOs and CTAs of "Up Front" Fees and Organizational and Offering Expenses

Commodity Futures Trading Commission ("CFTC") Regulation [4.21(a)(7)] 4.24(i) states that the disclosure document of a CPO must contain a description of each expense which has been or is expected to be incurred by the pool. CFTC Regulation [4.31(a)(4)] 4.34(i) applies to CTAs and requires that the disclosure document of a CTA describe each fee which the CTA will charge the client. In addition, CFTC Regulation [4.21(h)] 4.24(w) and [4.31(g)] 4.34(o), respectively, require CPOs and CTAs to disclose all "material" information. These requirements have been incorporated into

NFA Compliance Rule 2-13. Because "up front" fees and charges can have a significant impact on the net operating equity of pools and managed accounts, the above NFA rule requires not only disclosure of the existence and the amount of the up front charges but also disclosure of [(1)] how the up front charges affect <u>the return which must be achieved to break even at the end of an investor's first year or</u> the initial amount of capital available for trading<u>. Furthermore,</u> [and (2)] the impact of the up front charges on net performance <u>must be included in the rate of return figures</u> [as] reflected on a CPO's or CTA's performance [table] <u>summary</u>.

A. *Disclosure of Prospective Up Front Fees and Charges*

<u>The disclosure document must disclose</u> [CPOs and CTAs that intend to charge] up front fees and expenses<u>, if any,</u> to participants in a pool or clients in a managed account [must disclose that fact in the disclosure document]. <u>NFA's Board of Directors believes</u> [To ensure] that investors [are] <u>should be</u> fully aware of not only the amount of such [charge] <u>fees and expenses</u> but also [its] <u>their</u> impact on <u>the return which must be achieved to break even at the end of the investor's first year or</u> the net proceeds that will be available at the outset for futures trading<u>. For a CPO, NFA Compliance Rule 2-13(b) provides that a CPO's disclosure document must include a break-even analysis presented in the manner prescribed by NFA's Board of Directors, which is described in a separate interpretive notice. (See ¶ 9023.) CTAs may provide similar information either through the use of a break-even analysis which complies with the requirements of Compliance Rule 2-13(b) and the accompanying interpretive notice or through the use of a dilution table.</u>

<u>If a CTA chooses to use a dilution table, the dilution table</u> [, such disclosure] should be highlighted in a tabular format on the cover page of the disclosure document [("dilution table")]. The suggested format for the table would detail a standardized amount of initial investment, all up front fees and charges, including all [organizational and offering expenses] <u>sales and administrative fees</u>, and the net proceeds that would be available for trading after deducting the up front expenses. If a [CPO or] CTA does not use standardized amounts, minimums or units for initial investments, the required table should be presented showing dilution of an investment of $1,000. Moreover, if the

results in the dilution table, without further explanation, could be materially misleading as to the impact of the up front fees and charges on the amount of initial capital available for trading (for example, because the fees as a percentage of the initial investment vary depending on the amount of the investment), then explanatory footnotes should be used.

The extent to which a [CPO or] CTA breaks down the up front expenses into categories, including, but not limited to, <u>sales and administrative</u> fees, [organizational and offering expenses, legal fees and accounting fees,] is solely within the discretion of the [CPO or] CTA as long as the net proceeds for trading and the portion that is deducted from the initial investment are clearly delineated as such. All fees that are charged up front must be disclosed except that a [CPO or] CTA that charges periodic management fees on the first day of each period, including the initial period, need not describe such fees for the first period in the dilution table.

B. *Treatment of Up Front Fees in the Performance [Table] <u>Summary</u>*

[CPOs and CTAs that charge up front fees and expenses to participants or clients must reflect contributions to a pool or beginning equity balances of a managed account before consideration of such expenses in preparing the performance table required by NFA Rules. However, a CTA acting as an independent advisor to a commodity pool is not required to incorporate into the beginning equity balance of its performance table, the up front fees or organizational or offering expenses charged by the CPO.]

<u>In preparing rate of return information, the beginning net asset value of a pool or managed account must be calculated before any up front fees and expenses, including organizational and offering expenses, are deducted. However, a CTA acting as an independent advisor to a commodity pool is not required to include the up front fees or expenses charged by the CPO in beginning net asset value for purposes of calculating rate of return information for the CTA's own disclosure document.</u>

All up front fees and [organizational] expenses must be reflected as a reduction of net performance in the period in which the contribution was made to the pool or client's managed account, unless such fees and expenses can be amortized pursuant to Generally Accepted Accounting Principles.[1] If organization or syndication expenses can be, and are, amortized, then net performance shall be reduced each month by the monthly amortizable amount. The monthly amortizable amount shall be calculated by dividing the total amount of amortizable expenses by the total number of months over which such expenses shall be amortized.

C. Proposed Adoption of Interpretive Notice to NFA Compliance Rule 2-10 Relating to the Allocation of Block Orders for Multiple Accounts

NFA COMPLIANCE RULE 2-10

INTERPRETIVE NOTICE RELATING TO THE ALLOCATION OF BLOCK ORDERS FOR MULTIPLE ACCOUNTS

CFTC Regulation 1.35 requires that each FCM receiving a customer order immediately prepare a written record of the order which includes an appropriate account identification. The purpose of the regulation is to prevent various forms of customer abuse, such as fraudulent allocation of trades, by providing an adequate audit trail which allows customer orders to be tracked at every step of the order processing system. Since this regulation was originally adopted, however, there have been dramatic changes in the way business is done. With the explosive growth of the managed funds business and the increasing use of "give-up" agreements, it is not at all uncommon for some CTAs to place block orders for hundreds of accounts on markets around the world, with orders executed by one or more FCMs and cleared by other FCMs. How the basic requirements of CFTC Regulation 1.35 apply to block orders for multiple accounts has been the source of considerable difficulty and confusion.

With respect to block orders, CFTC Regulation 1.35 provides that, at or before the time the order is placed,

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[1] Section 709 of the Internal Revenue Code, 26 U.S.C. § 709, governs whether or not organization or syndication expenses incurred to organize and to promote the sale of interests in a partnership can be amortized.

the FCM must be provided with information which identifies the accounts included in the block order and which specifies the number of contracts to be allotted to each account. In most instances, a CTA can verbally provide all of that information contemporaneously with the placement of the order. Some of the time, however, this is not practical. Verbal transmission of numerous account numbers and allocation information could easily result in significant price slippage in filling block market orders. Most CTAs can deal with this problem by pre-filing with the FCM standing instructions which contain all of the necessary information.

For a limited number of larger and more sophisticated CTAs, however, pre-filing standing instructions is not practical either. These CTAs typically have very dynamic trading programs and change the allocations of contracts to accounts included in the block order on a daily basis. Though these CTAs could provide the allocation information to the FCM well in advance of each order, no responsible CTA would want to disclose its trading strategies in advance for a variety of reasons.

In general, then, there are two alternatives to the verbal filing of all account identification data contemporaneously with order placement:

1) Pre-filing of instructions for identification of accounts included in block orders and the allocation of executed block orders to accounts; and

2) under the stringent requirements described below, the contemporaneous filing of allocation instructions via electronic transmission.

This Interpretive Notice clarifies how either approach can be implemented consistent with the requirements of CFTC Regulation 1.35.

PRE-FILING OF ALLOCATION INSTRUCTIONS

Allocation instructions for trades made through block orders for multiple accounts must deal with two separate issues. The first, which arises in all such orders, involves the question of how the total number of contracts should be allocated to the various accounts included in the block order. The second involves the allocation of split or partial fills. For example, a CTA may place a block order of 100 contracts for multiple accounts. In many instances, however, a market order for 100 contracts may be filled at a number of different prices. Similarly, if an order is to be filled at a particular price, the FCM may be able to execute some but not all of the 100 lot order. In either example, the question arises of how the different prices or the contracts in the partial fill should be allocated among the accounts included in the block order.

The same set of core principles govern the procedures to be used in handling both of these issues. Any procedure for the general allocation of trades or the allocation of split and partial fills must be:

- designed to meet the overriding regulatory objective that allocations are non-preferential, such that no account or group of accounts receive consistently favorable or unfavorable treatment.

- sufficiently objective and specific that the appropriate allocation for any given trade can be verified in any audit by NFA, an exchange DSRO, the CFTC or the Member's own accountants.

- consistently applied by the Member firm.

In performing audits, we have noted that Members employ a wide variety of methods to allocate split and partial fills, some of which satisfy the standards stated above and some of which do not. The following examples of procedures for the allocation of split and partial fills generally satisfy the standards stated above.

Example #1 - Rotation of Accounts

One basic allocation procedure involves a rotation of accounts on a regular cycle, usually daily or weekly, which receive the most favorable fills. For example, if a firm has 100 accounts trading a particular trading program, in the first phase of the cycle, Account #1 receives the best fill, Account #2 the second best, etc. In phase 2 of the cycle, Account #2 receives the best fill and Account #1 moves to the end of the line and receives the least favorable fill.

Example #2 - Random Allocation

Some firms prepare on a daily basis a computer generated random order of accounts and allocate the best price to the first account on the list and the worst to the last. This method would satisfy the standards stated above.

Example #3 - Highest Prices to the Highest Account Numbers

Some firms rank accounts in order of their account numbers and then allocate the highest fill prices to the accounts with the highest account numbers. Any advantage the higher numbered accounts enjoy on the sell order are theoretically offset by the disadvantage on the buy orders. Although under certain market conditions this may not always be true, the method generally complies with the standards.

Though the examples cited above are the ones NFA most commonly sees in audits, they are by no means exhaustive. We would also note that 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. In addition, certain variations of these basic methods would not satisfy those requirements. For example, it would not be acceptable for the CTA to deviate from the regular rotation to accommodate an account whose performance is lagging behind others in the same program. This would inject the CTA's subjective judgment into the process, would render the allocation impossible to duplicate in the audit process and would open the potential for customer abuse.

One related issue which has generated some confusion is whether the responsibility for the allocation of split and partial fills rests with the CTA or with the FCM. The CTA certainly has the sole responsibility for ensuring that the procedures are appropriate in light of its approach to trading. With respect to the actual implementation of the procedures, since the CTA is directing the trading in the accounts, the responsibility for allocating split and partial fills among the accounts should rest with the CTA. However, there is nothing under NFA rules to preclude an FCM from agreeing to undertake this responsibility, whether it clears or executes the trades, pursuant to either its own procedures or to those supplied by the CTA. If the FCM agrees to do so, that agreement should be in writing. If the allocations are performed by the CTA pursuant to its own procedures, those procedures should nonetheless be on file with the FCM.

There is also a good deal of confusion on how the basic principles of CFTC Regulation 1.35 apply to block orders executed on a "give-up" basis, a process which was essentially unknown when Regulation 1.35 was originally adopted. Subject to exchange rules, in any given block order there may be multiple executing FCMs, multiple clearing FCMs or multiple FCMs serving each of these functions. The exact form of customer identification which the FCM must receive from the CTA under Regulation 1.35 may vary depending on the FCM's role in filling the order. Essentially, each FCM or floor broker must receive sufficient information to allow it to perform its function. For executing FCMs or floor brokers, this includes, at a minimum, the number of contracts to be given up to each clearing FCM and instructions for allocation of split and partial fills among those FCMs. Information concerning the number of contracts to be allocated to each account included in the block order must be provided to the FCM which will carry out those instructions, which, in most cases, will be the FCM clearing the accounts. All of this information must be provided at or before the time the order is placed and could be provided by pre-filing a set of instructions. If the pre-filed instructions for the general allocation or the allocation of split and partial fills meet the standards set forth in this Notice, then the clerical task of implementing the instructions could be performed by either the FCM or the CTA.

CONTEMPORANEOUS FILING OF INSTRUCTIONS VIA ELECTRONIC TRANSMISSION

Instructions for the allocation of contracts to accounts included in a block order can also be given at the time the CTA places the trade. NFA notes, however, that as a general rule allocation procedures for split and partial fills should be prefiled with the appropriate FCM. For instructions on the number of contracts to be assigned to each account in the block order, many CTAs simply provide the necessary allocation information by phone when they call in the block order. For a limited number of larger CTAs, however, providing allocation instructions verbally when the block order is placed is not a practical option. These CTAs may have hundreds of accounts included in the block order and providing detailed allocation information by phone would be extremely time consuming. Delaying the execution of the order while that process drags on could ultimately harm customers through market price slippage. It is also impractical for these larger CTAs to pre-file with the FCM a standing set of allocation instructions. The trading programs used by these CTAs are complex and dynamic. Given the fine tuning adjustments that are made on a daily basis, the exact number of contracts these CTAs allocate to any given account can vary from one day to the next. Theoretically, of course, the CTA could provide the FCM with detailed information on the allocation of contracts to each account included in the block order in advance of each such order. However, all CTAs, large and small, are reluctant to disclose their trading strategies in advance.

Under these circumstances, one way the CTA can provide the account identification information required under CFTC Regulation 1.35 would be to send the FCM, by facsimile or other form of electronic transmission, the breakdown of contracts to be assigned to each account included in the block order. The CTA would have to begin to send that information at the time the order is placed. Given the possibility of busy signals, paper jams and other limitations of electronic transmissions, there may be momentary delays in the completion of the transmission. Such delays should be neither commonplace nor lengthy, and the CTA should maintain appropriate documentation whenever such delays occur. When those delays do occur, however, CFTC Regulation 1.35 does not necessarily require the FCM to delay execution of the order until the electronic transmission of the allocation information is completed. To avoid delays in execution due to such transmission difficulties, the CTA must have provided the FCM with a written certification that:

(1) the CTA will begin the transmission to the FCM of the allocation breakdown contemporaneously with the place-

ment of the order and will maintain appropriate documentation regarding any delays experienced in such transmission;

(2) prior to the placement of an order, the CTA has also generated a non-preferential allocation breakdown for each order which has been computer time-stamped indicating the date on which the order is to be placed and the date and time the allocation breakdown was printed;

(3) the CTA maintains with either their executing or clearing FCMs a complete list of all accounts traded by the CTA, by trading program if applicable;

(4) if a bunched order does not include all accounts within a particular trading program, then prior to the execution of the order these CTAs will identify for their FCMs the accounts which are included, by account identifier or designation;

(5) on a daily basis, these CTAs confirm that all their accounts have the correct allocation of contracts; and

(6) at least once a month, these CTAs analyze each trading program to ensure that the allocation method has been fair and equitable. If divergent performance results exist over time, then such results must be shown to be attributable to factors other than the CTA's trade allocation or execution procedures.

An FCM which relies in good faith on the above certification would be deemed to be in compliance with CFTC Regulation 1.35. The CTA must also file a copy of that certification with NFA at least thirty days prior to implementing these procedures. This time period will provide NFA with an opportunity to review and verify the information contained in the certification. The CTA must be able to demonstrate on a continuing basis that the information in the certification is correct and could face disciplinary action for a failure to do so. Based on NFA's auditing experience, we note that only those CTAs with relatively sophisticated back office operations could meet the requirements for certification in this Notice. If any Member has questions concerning how this Interpretive Notice would apply to its operations, please contact NFA's Compliance Department.

EXPLANATION OF AMENDMENTS

A. Explanation of Amendments to NFA Compliance Rule 2-13

As you know, the Commission amended CFTC Regulation 4.21(a) to allow CPOs to provide accredited investors with a notice of intended offering and statement of terms of the intended offering ("notice of intended offering") prior to delivering a disclosure document. Under CFTC Regulation 4.21(a), the notice of intended offering can only be given "subject to compliance with rules promulgated by a registered futures association...."

The proposed amendments to NFA Compliance Rule 2-13 are generally patterned after SEC Rule 135. They have, of course, been adapted to fit commodity pools and reflect that the notice can be directed only to accredited investors.

Proposed NFA Compliance Rule 2-13(d) allows CPOs to provide accredited investors with a notice of intended offering that includes any or all of the following information:

- the name of the CPO and the pool;
- a brief description of the limited partnership interests being sold;
- when the interests will be sold and a brief description of the manner and purpose of selling the interests;
- the type of pool, and the name of the CTA if it is a single-advisor pool;
- limitations on who may invest in the pool, such as state-imposed suitability requirements;
- any legend required by a regulator, such as a state securities commissioner; and
- who to contact to obtain a copy of the disclosure document.

A disclosure document must be provided to the accredited investor upon request or before selling him any limited partnership interests. Finally, the proposed amendment provides that the notice cannot be given in any manner that is likely to reach non-accredited investors.

B. Explanation of Amendments to the Guideline for the Disclosure by CPOs and CTAs of "Up Front" Fees and Organizational and Offering Expenses

Approximately ten years ago, NFA's Board adopted a Guideline for the Disclosure by CPOs and CTAs of "Up Front" Fees and Organizational and Offering Expenses ("the Guideline"). The Guideline is an interpretation of NFA Compliance Rule 2-13 which requires, among other things, that CPOs and CTAs include a dilution table on the front page of their disclosure documents to show the effect that up front fees and expenses have on the amount that will be available for trading.

As you are aware, the Commission recently approved amendments to NFA Compliance Rule 2-13 which require CPOs to include a break-even analysis in their disclosure documents. Since the break-even analysis is designed to notify potential pool participants of the practical effect that fees and expenses, including organizational and offering expenses, have on their initial investments, the break-even analysis serves a function similar to that served by the dilution table. Therefore, the Board amended the Guideline to eliminate the essentially duplicative requirement that CPOs include a dilution table in their disclosure documents. The Board also amended the Guideline to give CTAs the option of using either the dilution table or the break-even analysis.

Several technical amendments to the Guideline are also necessary due to the recent changes to the Part 4 rules. These amendments reflect changes to the numbering system for the Part 4 rules and the use of a performance summary instead of the traditional performance table.

C. Explanation of Proposed Adoption of an Interpretive Notice to NFA Compliance Rule 2-10 Relating to the Allocation of Block Orders for Multiple Accounts

CFTC Regulation 1.35 provides that, at or before the time a block order is placed, each FCM receiving the order must be provided with information which identifies the accounts included in the block order and specifies the number of contracts to be allocated to each account. As the Commission has recognized, under certain circumstances, a rigid reading of CFTC Regulation 1.35 could result in inefficient order execution procedures to the detriment of customers. One such circumstance involves large CTAs with sophisticated computer trading systems, multiple executing and clearing FCMs and a large number of customer accounts. These CTAs place bunched orders but do not want to supply their FCMs with advance notice of allocation information. These CTAs and their FCMs generally believe that providing such order size information may enhance the possibility of front running or other third party abuses to the detriment of customers. In particular, these CTAs are hesitant to allow trading floor personnel access to order size information and therefore, possibly, the CTA's proprietary trading strategy. According to these CTAs, confidentiality relating to the size of orders is the best means available to guard against the aforementioned customer abuses. Additionally, if these CTAs were required to provide complete allocation information prior to the execution of an order, then customers may again suffer from market price slippage while the allocation information is either verbally or electronically (i.e., via facsimile) transmitted to a CTA's multiple FCMs.

NFA staff has discussed the difficulties experienced by these CTAs with the Managed Futures Association, the CPO/CTA and FCM Advisory Committees and individual Member firms. In drafting the Interpretive Notice, NFA staff also obtained input from NFA's Special Committee for the Review of a Multi-tiered Regulatory Approach to NFA Rules and from an ad hoc committee comprised of various industry participants, including CTA, FCM and exchange representatives.

The proposed Interpretive Notice discusses two alternative methods to the verbal filing of account identification and allocation data contemporaneously with order placement. The Interpretive Notice clarifies how either alternative can be implemented consistent with the requirements of CFTC Regulation 1.35.

Pursuant to the first alternative discussed in the Interpretive Notice, a CTA provides its FCM with a pre-filed set of instructions identifying the accounts included in block orders and the allocation of contracts to accounts included in executed block orders. The Interpretive Notice notes that two issues arise in connection with the use of pre-filed allocation instructions: (1) how to allocate the total number of contracts to the various accounts included in the block order; and (2) how to allocate split or partial fills. With regard to these issues, the Interpretive Notice discusses three core principles which govern allocation procedures and, consistent with these principles, it discusses several methods to allocate split and partial fills (i.e. rotation of accounts, random allocation and highest prices to the highest account numbers).

Furthermore, with regard to split and partial fill allocation procedures, the Interpretive Notice makes clear that a CTA has the sole responsibility to ensure that the procedures are appropriate in light of its trading approach. Since the CTA directs the trading in accounts, the responsibility for allocating split and partial fills among the accounts should rest with the CTA. If these allocations are performed by the CTA pursuant to its own procedures, those procedures should be on file with the FCM. Additionally, the Interpretive Notice notes that nothing under NFA's rules precludes an FCM from agreeing to undertake this responsibility pursuant to either its own or the CTA's procedures. However, if the FCM agrees to do so, that agreement should be in writing.

The Interpretive Notice also discusses how the basic principles of CFTC Regulation 1.35 apply to block orders executed on a "give-up" basis. Subject to exchange rules, in any given block order there may be multiple executing FCMs, multiple clearing FCMs or multiple FCMs serving each of these functions. The exact form of customer identification which the FCM must receive from the CTA under Regulation 1.35 may vary depending on the FCM's role in filling the order. Essentially, each FCM or floor broker must receive sufficient information to allow it to perform its function. For executing FCMs or floor brokers, this includes, at a minimum, the number of contracts to be given up to each clearing FCM and instructions for the allocation of split and partial fills among those FCMs. Information concerning the number of contracts to be allocated to each account included in the block order must be provided to the FCM which will carry out those instructions, which, in most cases, will be the FCM clearing the accounts. All of this information must be provided at or before the time the order is placed and could be provided by pre-filing a set of instructions.

Pursuant to the second alternative, under certain specified and stringent circumstances, a CTA may send its FCM, by facsimile or other form of electronic transmission, instructions relating to account identification and the allocation of contracts included in the block order contemporaneously with the placement of an order. Given the possibility of busy signals, paper jams and other limitations of electronic transmissions, there may be momentary delays in the completion of the transmission. Such delays should be neither commonplace nor lengthy, and the CTA should maintain appropriate documentation whenever such delays occur. The Board believes that when those delays do occur, however, CFTC Regulation 1.35 does not necessarily require the FCM to delay execution of the order until the electronic transmission of the allocation information is completed. However, to avoid delays in execution due to such transmission difficulties, a CTA must have provided its FCM with a written certification meeting the detailed requirements set forth in the Interpretive Notice. Specifically, among other items, a CTA must certify that: (1) the transmission to the FCM of the allocation breakdown will begin contemporaneously with the placement of an order and the CTA will maintain appropriate documentation regarding any delays; (2) prior to or contemporaneously with the placement of an order, a computer time-stamped non-preferential allocation breakdown for each order has been generated; and (3) at least once a month, each trading program will be analyzed to ensure that the allocation method has been fair and impartial. The CTA must also file the certification with NFA at least thirty days prior to implementing these procedures. This time period will provide NFA with an opportunity to review and verify the information contained in the certification.

An FCM which relies in good faith on the above certification would be deemed to be in compliance with CFTC Regulation 1.35. The CTA must be able to demonstrate at all times that the information in the certification is correct and could face disciplinary action for a failure to do so. NFA notes, based upon its auditing experience, that only those CTAs with relatively sophisticated back office operations could truthfully make the certifications required in this Notice.

The Board believes that the order execution procedures set forth in the Interpretive Notice comply with CFTC Regulation 1.35 and, at the same time, provide guidance to Members relating to account identification and allocation procedures.

NFA respectfully requests that the Commission review and approve the proposals contained in this submission and requests that they be declared effective upon Commission approval.

Respectfully submitted,

Daniel J. Roth

Daniel J. Roth
General Counsel

cc: Chairman Mary L. Schapiro
Commissioner Barbara Pedersen Holum
Commissioner Joseph P. Dial
Commissioner John E. Tull, Jr.
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DJR:ckm(sub\111695)

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DIVISION OF
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February 15, 1996

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Re: National Futures Association's Proposed Amendments to Compliance Rule 2-13 and the Guideline for the Disclosure by Commodity Pool Operators and Commodity Trading Advisors of "Up Front" Fees and Organizational and Offering Expenses

Dear Mr. Roth:

By letter dated December 7, 1995, and received December 12, 1995, the National Futures Association ("NFA") submitted to the Commission for its approval, pursuant to Section 17(j) of the Commodity Exchange Act ("Act"), proposed amendments to Compliance Rule 2-13 and the Guideline for the Disclosure by Commodity Pool Operators ("CPOs") and Commodity Trading Advisors ("CTAs") of "Up Front" Fees and Organizational and Offering Expenses ("Up Front Fees Guideline"). Based upon its review, the Division of Trading and Markets ("Division") has identified the following matters which NFA should address in order to further explain and justify both proposed amendments.

I. <u>Proposed Amendment to Compliance Rule 2-13</u>

1. Current Compliance Rule 2-13(c) requires that members file with NFA copies of any documents or notices that they are required to file with the Commission pursuant to "Regulations 4.13 and 4.16 through 4.32." The Division notes that at the present time Commission Regulation 4.32 is reserved. Please submit to the Commission an appropriate amendment to this provision.

2. a. The proposed amendment to Compliance Rule 2-13 would establish requirements permitting member CPOs to deliver notices of intended offerings and statements of terms ("intended offering notices") to accredited investors. The proposal would require that an intended offering notice include "no more" than certain types of enumerated information. Please explain what, if any, minimum amount of information NFA would require in an intended offering notice.

b. For example, NFA's proposal would require that member CPOs provide a disclosure document to any accredited investor "upon request or prior to accepting or receiving funds, securities, or other property from the accredited investor" for investment in a pool. However, NFA's proposal permits, but does not require, that CPOs include their name, address and telephone number in any intended offering notice. Please explain why NFA is proposing to make the provision of this information optional, rather than mandatory, when it would seem that such information would facilitate investors contacting CPOs to obtain disclosure documents.

3. Proposed NFA Compliance Rule 2-13(d)(4) states that an intended offering notice may include the "anticipated time of the offering." Does this refer to the length of time of the offering, the date the offering will be made or both? Please explain.

4. Proposed NFA Compliance Rule 2-13(d)(4) states that an intended offering notice may include a brief statement as to the "purposes" of the offering. Please explain what type of information would be covered by this clause.

5. Proposed NFA Compliance Rule 2-13(d)(5) states that only a single-advisor pool's intended offering notice may include the name of its CTA. Under this provision, could an intended offering notice for a principal-protected pool also include the name of its CTA? Please explain.

6. Proposed NFA Compliance Rule 2-13(d) states that a CPO must provide a disclosure document to an accredited investor "upon request or prior to accepting or receiving funds, securities, or other property from the accredited investor" for the purposes of investing in a pool. The Division believes that the use of the word "or" in this context may be confusing and could be interpreted to mean that a CPO need not provide a disclosure document to an accredited investor if the investor does not request a disclosure document. Would the NFA consider replacing "or" with the phrase "and, in any event"? Please respond.

II. <u>Proposed Amendment to the Guideline for the Disclosure by CPOs and CTAs of "Up Front" Fees and Organizational and Offering Expenses</u>

1. The first paragraph of the proposed amended Up Front Fees Guideline requires that the impact of up front charges on net performance "must be included in the rate of return figures" of a CPO's or CTA's performance summary. What rate of return ("ROR") figures does this provision refer to? Does it pertain only to the ROR for the pool or trading

program being offered or does it also include RORs for any other pools or programs? Please explain.

2. Under the proposal, the last paragraph of Section A of the Up Front Fees Guideline would provide that a CTA that charges periodic management fees on the first day of each period "need not describe such fees for the first period in the dilution table." Please explain why the NFA would not require such a description.

3. Under NFA's proposal, the title to Section B of the Up Front Fees Guideline refers to a "performance summary." The Division believes that this reference could be misleading and suggests that the title be renamed "Treatment of Up Front Fees in the Required Past Performance Presentation." Note that the first paragraph of the Guideline also refers to a "performance summary."

4. a. The new first paragraph of Section B of the proposed amended Up Front Fees Guideline states that a CTA acting as "an independent advisor to a commodity pool is not required to include the up front fees or expenses charged by the CPO in beginning net asset value for purposes of calculating [ROR] information for the CTA's own disclosure document." In this context, would a CTA which is unaffiliated with a pool it advises be considered an "independent advisor?" Please explain what types of activity would constitute acting as an independent advisor to a pool.

   b. Are there any circumstances in which an independent CTA advising a pool should include the pool's up front fees and expenses in reporting its performance? If so, the proposed amendment should reflect these situations.

5. The last paragraph of the current and proposed versions of Section B of the Up Front Fees Guideline provides that, subject to certain other conditions, up front fees and expenses must be reflected as a reduction of net performance in the period in which the "contribution" was made to the pool or managed account. Please clarify and explain what type(s) of contribution(s) NFA intends to cover with this provision.

If you have any questions concerning the issues raised in this letter, please contact David P. Van Wagner at (202) 418-5481.

Sincerely,

David P. Van Wagner

David P. Van Wagner
Special Counsel

NFA NATIONAL FUTURES ASSOCIATION
200 W. MADISON ST. • CHICAGO, IL • 60606-3447 • (312) 781-1300

March 6, 1996

David P. Van Wagner
Special Counsel
Commodity Futures Trading Commission
Three Lafayette Centre
1155 21st Street, NW
Washington, D.C. 20581

Re: Proposed Amendments to Compliance Rule 2-13 and the Guideline for the Disclosure by Commodity Pool Operators and Commodity Trading Advisors of "Up Front" Fees and Organizational and Offering Expenses.

Dear Mr. Van Wagner:

This is in response to your February 15, 1996 letter posing a number of questions regarding two proposals submitted to the Commission by NFA on December 7, 1995. I will respond to your questions in the order presented.

I. Proposed Amendment to Compliance Rule 2-13

Question 1: Current Compliance Rule 2-13(c) requires that Members file with NFA copies of any documents or notices that they are required to file with the Commission pursuant to "Regulations 4.13 and 4.16 through 4.32." The Division notes that at the present time Commission Regulation 4.32 is reserved. Please submit to the Commission an appropriate amendment to this provision.

Answer: In reviewing this question, NFA noted that Compliance Rule 2-13(c) has not been updated to reflect the renumbering of several Commission Regulations under Part 4 as a result of the Commission's recent amendments. Therefore, NFA proposes amending Rule 2-13 to require NFA Members to file with NFA any notice or document required to be filed with the CFTC under CFTC Regulations 4.7, 4.22, 4.26, or 4.36. An amendment to Rule 2-13 incorporating this change will be presented to NFA's Board of Directors at its next scheduled meeting.

Question 2 a: The proposed amendment to Compliance Rule 2-13 would establish requirements permitting Member CPOs to deliver notices of intended offerings and statements of terms ("intended offering notices") to accredited investors. The proposal would require that an intended offering notice include "no more" than certain types of enumerated information. Please explain what, if any, minimum amount of information NFA would require in an intended offering notice.

Question 2 b: For example, NFA's proposal would require that Member CPOs provide a disclosure document to any accredited investor "upon request or prior to accepting or receiving funds, securities, or other property from the accredited investor" for investment in a pool. However, NFA's proposal permits, but does not require, that CPOs include their name, address and telephone number in any intended offering notice. Please explain why NFA is proposing to make the provision of this information optional rather than mandatory, when it would seem that such information would facilitate investors contacting CPOs to obtain disclosure documents.

Answer: NFA Compliance Rule 2-13(d) is patterned after similar SEC rules which under certain circumstances permit but do not require the use of an intended offering notice which may contain only certain enumerated information. The SEC rules do not set forth any information which must be included in the notice. This framework has been carried forward to Rule 2-13 which also permits, under certain circumstances, the use of an intended offering notice but limits the information which may be included. NFA does not intend, nor does it see the need, to make any information mandatory.

Furthermore, NFA believes that it is unnecessary to require that the name, address and telephone number of the CPO be included in the notice in order to ensure that potential investors receive a copy of the disclosure document. The CPO is required by Commission and NFA rules to deliver the disclosure document before accepting an investment from a potential customer. The fact that the CPO utilizes an intended offering notice will not eliminate the CPO's obligation to provide the disclosure document. As a practical matter, however, it seems only logical that a CPO would choose to provide its name, address, and telephone number whenever it is allowed to do so.

Question 3: Proposed NFA Compliance Rule 2-13(d)(4) states that an intended offering notice may include the "anticipated time of the offering." Does this refer to the length of time of the offering, the date the offering will be made or both? Please explain.

Answer: The language "anticipated time of the offering" refers to both the date the offering will be made and the time period it will remain open. For example, if an offering commenced on June 30, 1996 and was scheduled to remain open until June 30, 1997, Rule 2-13 would permit the disclosure of this information. In addition, if an offering did not have a closing date, Rule 2-13 would permit the notice to state that the offering is continuous.

Question 4: Proposed NFA Compliance Rule 2-13(d)(4) states that an intended offering notice may include a brief statement as to the "purposes" of the offering. Please explain what type of information would be covered by this clause.

Answer: A brief statement as to the "purpose" of the offering was intended to permit CPOs to indicate whether the pool was a speculative or hedge vehicle. In reviewing Commission staff's question on this provision, NFA staff recognized that it might be more appropriate to include reference as to whether a pool is for speculative or hedge purposes as a component of Section (d)(5) of Rule 2-13 (e.g. type of pool). Therefore, NFA suggests that the reference to "purposes" in 2-13(d)(4) be deleted and a reference to whether a pool is for speculative or hedge purposes be added to 2-13(d)(5). Please advise whether Commission staff believes that this change would be beneficial. If so, NFA will present the appropriate amendment to the Board of Directors at its next scheduled meeting.

Question 5: Proposed NFA Compliance Rule 2-13(d)(5) states that only a single-advisor pool's intended offering notice may include the name of its CTA. Under this provision, could an intended offering notice for a principal-protected pool also include the name of its CTA? Please explain.

Answer: A pool can fit within more than one category for purposes of NFA Compliance Rule 2-13(d)(5). An intended offering notice for a principal-protected pool may include the name of its CTA provided the pool has only one advisor.

Question 6: Proposed NFA Compliance Rule 2-13(d) states that a CPO must provide a disclosure document to an accredited investor "upon request or prior to accepting or receiving funds, securities, or other property from the accredited investor" for the purposes of investing in a pool. The Division believes that the use of the word "or" in this context may be confusing and could be interpreted to mean that a CPO need not provide a disclosure document to an accredited investor if the investor does not request a disclosure document. Would the NFA consider replacing "or" with the phrase "and, in any event?" Please respond.

Answer: Although NFA is willing to make the change suggested by Commission staff, NFA believes that the current language makes it clear that "upon request" and "prior to accepting funds" are alternative scenarios which each require the delivery of a disclosure document. NFA does not see how this language could be interpreted to provide that a CPO need only deliver a disclosure document prior to accepting or receiving funds if the accredited investor requests one. In fact, NFA believes the use of the word "and" may imply that the disclosure document must be provided only if both conditions are present (i.e., the accredited investor requests the document and the CPO accepts funds from the investor for purposes of investing in the pool.) Please advise NFA whether Commission staff continues to see the need for the change. If so, NFA will present the appropriate amendment to NFA's Board of Directors at its next scheduled meeting.

II. Proposed Amendment to the Guideline for the Disclosure by CPOs and CTAs of "Up Front" Fees and Organizational and Offering Expenses

Question 1: The first paragraph of the proposed amended Up Front Fees Guideline requires that the impact of up front charges on net performance "must be included in the rate of return figures" of a CPO's or CTA's performance summary. What rate of return ("ROR") figures does this provision refer to? Does it pertain only to the ROR for the pool or trading program being offered or does it also include RORs for any other pools or programs? Please explain.

Answer: At the outset, NFA notes that this change to the interpretive notice is not substantive and does not in any way alter the framework adopted ten years ago which requires CPOs and CTAs to disclose the impact of up front fees on the net proceeds which will be available for trading. If performance information is provided for a pool or managed account which charges an up front fee, regardless of whether it is the pool or trading program being offered, the interpretive notice requires -- as it always has -- that the rate of return calculation for that particular pool or managed account disclose the impact of the up front fee charged to that pool or managed account.

Question 2: Under the proposal, the last paragraph of Section A of the Up Front Fees Guideline would provide that a CTA that charges periodic management fees on the first day of each period "need not describe such fees for the first period in the dilution table." Please explain why the NFA would not require such a description.

Answer: NFA does not require that this type of management fee be included in the dilution table because we do not consider it to be an up front fee. Although the fee is not reflected in the dilution table, it is included in the performance information for that period. Again, NFA notes that this treatment of periodic management fees is not a change from the existing interpretive notice.

Question 3: Under NFA's proposal, the title to Section B of the Up Front Fees Guideline refers to a "performance summary." The Division believes that this reference could be misleading and suggests that the title be renamed "Treatment of Up Front Fees in the Required Past Performance Presentation." Note that the first paragraph of the Guideline also refers to a "performance summary."

Answer: If Commission staff believes that the above noted language change is necessary, NFA will make the suggested change. NFA, however, fails to see how the reference to "performance summary" could be misleading or how the Division's proposed language is a substantive change. Please advise NFA why Commission staff believes this change is necessary.

Question 4 a: The new first paragraph of Section B of the proposed amended Up Front Fees Guideline states that a CTA acting as "an independent advisor to a commodity pool is not required to include the up front fees or expenses charged by the CPO in beginning net asset value for purposes of calculating [ROR] information for the CTA's own disclosure document." In this context, would a CTA which is unaffiliated with a pool it advises be considered an "independent advisor?" Please explain what types of activity would constitute acting as an independent advisor to a pool.

Question 4 b: Are there any circumstances in which an independent CTA advising a pool should include the pool's up front fees and expenses in reporting its performance? If so, the proposed amendment should reflect these situations.

Answer: NFA notes that the new first paragraph of Section B merely clarifies the language of the existing interpretive notice and does not in any way alter the substantive requirements of this section which were adopted 10 years ago. If, however, Commission staff feels that the term "independent advisor" needs clarification, NFA will be happy to do so. In general, an independent advisor to a pool refers to a CTA which is not an affiliate of the CPO or does not receive any portion of the up front fee. For these purposes, "affiliate" means any person or entity which owns or controls, is owned or controlled by, or is under common ownership or control with the CPO. If the advisor is an affiliate of the CPO or receives a portion of the up front fee, the advisor would, of course, be required to include the fee in beginning net asset value for purpose of calculating its rate of return information. NFA does not foresee, and in 10 years of experience with the Rule has not encountered, any other circumstance where a CTA should be required to include up front fees and expenses in its performance information.

Question 5: The last paragraph of the current and proposed versions of Section B of the Up Front Fees Guideline provides that, subject to certain other conditions, up front fees and expenses must be reflected as a reduction of net performance in the period in which the "contribution" was made to the pool or managed account. Please clarify and explain what types(s) of contribution(s) NFA intends to cover with this provision.

Answer: That term "contribution" refers to an investment in a pool or funds deposited into a managed account.

I hope that this letter has been responsive to Commission staff's concerns. If you have any additional questions, please do not hesitate to contact me.

Sincerely,

Daniel J. Roth
General Counsel

/pjf(Ltrs/VanW1.CAW)

NATIONAL FUTURES ASSOCIATION
200 W. MADISON ST. • CHICAGO, IL • 60606-3447 • (312) 781-1300

May 28, 1996

Ms. Jean A. Webb
Secretariat
Commodity Futures Trading Commission
Three Lafayette Centre
1155 21st Street, N.W.
Washington, D.C. 20581

Re: National Futures Association: Resubmission of Proposed Amendments to NFA Compliance Rule 2-13 and Resubmission of Proposed Amendments to the Guideline for the Disclosure by CPOs and CTAs of "Up Front" Fees and Organizational and Offering Expenses

Dear Ms. Webb:

By letter dated December 7, 1995, National Futures Association ("NFA") submitted to the Commodity Futures Trading Commission ("Commission" or "CFTC") for its review and approval proposed amendments to NFA Compliance Rule 2-13 and proposed amendments to the Guideline for the Disclosure by CPOs and CTAs of "Up Front" Fees and Organizational and Offering Expenses ("the Guideline"). Those proposals were approved by NFA's Board of Directors on November 16, 1995.

Since that time, at the request of Commission staff, NFA made several technical changes to Rule 2-13 and changed it to conform with the new numbering system in the CFTC's Part 4 Regulations. Also at the request of Commission staff, NFA made minor changes to the Guideline to track the Commission's manner of referring to past performance presentations and to define what is meant by the term "independent advisor" in Section B of the Guideline.

NFA hereby substitutes the text of the previously submitted proposals with the revised text set forth below. The amendments contained herein were approved by NFA's Board of Directors on May 16, 1996. NFA respectfully requests Commission review and approval of them.

A) Proposed Amendments to NFA Compliance Rule 2-13 (additions <u>are underscored and deletions are bracketed)</u>:

COMPLIANCE RULES

* * *

Part 2 -- RULES GOVERNING THE BUSINESS CONDUCT OF MEMBERS REGISTERED WITH THE COMMISSION

* * *

Rule 2-13. CPO/CTA REGULATIONS.

(a) Any Member who violates any of CFTC Regulations 4.1 and 4.16 through 4.41 shall be deemed to have violated an NFA requirement.

(b) Each Member CPO which delivers or causes to be delivered a Disclosure Document under CFTC Regulation 4.21 must include in the Disclosure Document a break-even analysis which includes a tabular presentation of fees and expenses. The break-even analysis must be presented in the manner prescribed by NFA's Board of Directors.

(c) Each Member required to file any document with or give notice to the CFTC under CFTC Regulations 4.7, 4.22, 4.26 or 4.36 [4.13 and 4.16 through 4.32] shall also file one copy of such document with or give such notice to NFA at its Chicago office no later than the date such document or notice is due to be filed with or given to the CFTC. any CPO Member may file with NFA a request for an extension of time in which to file the annual report required by CFTC Regulation 4.22(c) or a request for approval of a change to its fiscal-year election by following the procedures set forth in NFA Financial Requirements Schedule E.

(d) A Member CPO may deliver a notice of intended offering and statement of terms to prospective participants who are accredited investors, as defined in 17 C.F.R. 230.501(a), prior to the delivery of a Disclosure Document, provided that the notice of intended offering and statement of terms clearly states that the offering will be made only by means of a disclosure document and includes no more than the following additional information:

(1) the name of the CPO, issuer, underwriter, and selling agent;

(2) the name of the pool;

(3) the title, amount, minimum escrow, and basic terms of the equity interests the CPO proposes to offer;

(4) the date the offering will be commenced and the length of time it will remain open, and a brief statement of the manner of the offering;

(5) the type of pool (e.g., multi-advisor, single-advisor, principal-protected, speculative or hedge) and interests to be traded and, for a single-advisor pool, the name of the CTA;

(6) any limitations regarding who may invest in the pool or the amount of any investment;

(7) any statement or legend required by any applicable laws, regulations, or rules or by any state, federal, or foreign regulator; and

(8) the name and address and/or telephone number to write or call in order to obtain a copy of the Disclosure Document.

Unless the pool is offered under CFTC Regulation § 4.7, the CPO must provide a Disclosure Document to the accredited investor upon request and, in any event, prior to accepting or receiving funds, securities, or other property from the accredited investor for the purpose of investing in the pool. A notice of intended offering and statement of terms may not be distributed by any means that is likely to reach persons who do not qualify as accredited investors under 17 C.F.R. 230.501(a).

B) Proposed Amendments to the Guideline for the Disclosure by CPOs and CTAs of "Up Front" Fees and Organizational and Offering Expenses (additions are underscored and deletions are bracketed):

Interpretation of NFA Compliance Rule 2-13: Guideline for the Disclosure by CPOs and CTAs of "Up Front" Fees and Organizational and Offering Expenses

Commodity Futures Trading Commission ("CFTC") Regulation [4.21(a)(7)] 4.24(i) states that the disclosure document of a CPO must contain a description of each expense which has been or is expected to be incurred by the pool. CFTC Regulation [4.31(a)(4)] 4.34(i) applies to CTAs and requires that the disclosure document of a CTA describe each fee which the CTA will charge the client. In addition, CFTC Regulation [4.21(h)] 4.24(w) and [4.31(g)] 4.34(o), respectively, require CPOs and CTAs to disclose all "material" information. These requirements have been incorporated into NFA Compliance Rule 2-13. Because "up front" fees and charges can have a significant impact on the net operating equity of pools and managed accounts, the above NFA rule requires not only disclosure of the existence and the amount of the up front charges but also disclosure of [(1)] how the up front charges affect the return which must be achieved to break even at the end of an investor's first year or the initial amount of capital available for trading. Furthermore, [and (2)] the impact of the up front charges on net performance must be included in the rate of return figures [as] reflected on a CPO's or CTA's required past performance presentation [table].

A. *Disclosure of Prospective Up Front Fees and Charges*

The disclosure document must disclose [CPOs and CTAs that intend to charge] up front fees and expenses, if any, to participants in a pool or clients in a managed account [must disclose that fact in the disclosure document]. NFA's Board of Directors believes [To ensure] that investors [are] should be fully aware of not only the amount of such [charge] fees and expenses but also [its] their impact on the return which must be achieved to break even at the end of the investor's first year or the net proceeds that will be available at the outset for futures trading. For a CPO, NFA Compliance Rule 2-13(b) provides that a CPO's disclosure document must include a break-even analysis presented in the manner prescribed by NFA's Board of Directors, which is described in a separate interpretive notice. (See ¶ 9023.) CTAs may provide similar information either through the use of a break-even analysis which complies with the requirements of Compliance Rule 2-13(b) and the accompanying interpretive notice or through the use of a dilution table.

If a CTA chooses to use a dilution table, the dilution table [, such disclosure] should be highlighted in a tabular format on the cover page of the disclosure document [("dilution table")]. The suggested format for the table would detail a standardized amount of initial investment, all up front fees and charges, including all [organizational and offering expenses] sales and administrative fees, and the net proceeds that would be available for trading after deducting the up front expenses. If a [CPO or] CTA does not use standardized amounts, minimums or units for initial investments, the required table should be presented showing dilution of an investment of $1,000. Moreover, if the results in the dilution table, without further explanation, could be materially misleading as to the impact of the up front fees and charges on the amount of initial capital available for trading (for example, because the fees as a percentage of the initial investment vary depending on the amount of the investment), then explanatory footnotes should be used.

The extent to which a [CPO or] CTA breaks down the up front expenses into categories, including, but not limited to, sales and administrative fees, [organizational and offering expenses, legal fees and accounting fees,] is solely within the discretion of the [CPO or] CTA as long as the net proceeds for trading and the portion that is deducted from the initial investment are clearly delineated as such. All fees that are charged up front must be disclosed except that a [CPO or] CTA that charges periodic management fees on the first day of each period, including the initial period, need not describe such fees for the first period in the dilution table.

B. *Treatment of Up Front Fees in the Required Past Performance Presentation [Performance Table]*

[CPOs and CTAs that charge up front fees and expenses to participants or clients must reflect contributions to a pool or beginning equity balances of a managed account before consideration of such expenses in preparing the performance table required by NFA Rules. However, a CTA acting as an independent advisor to a commodity pool is not required to incorporate into the beginning equity balance of its performance table, the up front fees or organizational or offering expenses charged by the CPO.]

In preparing rate of return information, the beginning net asset value of a pool or managed account must be calculated before any up front fees and expenses, including organizational and offering expenses, are deducted. However, a CTA acting as an independent advisor to a commodity pool is not required to include the up front fees or expenses charged by the CPO in beginning net asset value for purposes of calculating rate of return information for the CTA's own disclosure document. In general, a CTA is acting as an independent advisor if it is not an affiliate of the CPO and does not receive any portion of the up front fee. For these purposes, "affiliate" means any advisor which owns or controls, is owned or controlled by, or is under common ownership or control with the CPO.

All up front fees and [organizational] expenses must be reflected as a reduction of net performance in the period in which the contribution was made to the pool or client's managed account, unless such fees and expenses can be amortized pursuant to Generally Accepted Accounting Principles.[1] If organization or syndication expenses can be, and are, amortized, then net performance shall be reduced each month by the monthly amortizable amount. The monthly amortizable amount shall be calculated by dividing the total amount of amortizable expenses by the total number of months over which such expenses shall be amortized.

NFA respectfully requests that the Commission review and approve the proposals contained in this submission and requests that they be declared effective upon Commission approval.

Sincerely,

Daniel J. Roth
General Counsel

cc: Acting Chairman John E. Tull, Jr.
Commissioner Barbara Pedersen Holum
Commissioner Joseph P. Dial
Andrea M. Corcoran, Esq.
Geoffrey Aronow, Esq.
Alan L. Seifert, Esq.
Susan C. Ervin, Esq.
Lawrence B. Patent, Esq.
David Van Wagner, Esq.

DJR:ckm(sub\0596rsub)

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[1] Section 709 of the Internal Revenue Code, 26 U.S.C. § 709, governs whether or not organization or syndication expenses incurred to organize and to promote the sale of interests in a partnership can be amortized.

NFA NATIONAL FUTURES ASSOCIATION
200 W. MADISON ST. • CHICAGO, IL • 60606-3447 • (312) 781-1300

September 17, 1996

David P. VanWagner, Esq.
Special Counsel
Commodity Futures Trading Commission
Three Lafayette Centre
1155 21st Street, NW
Washington, D.C. 20581

Re: Proposed Amendments to the Guideline for the Disclosure by Commodity Pool Operators and Commodity Trading Advisors of "Up Front" Fees and Organizational and Operating Expenses

Dear Mr. VanWagner:

This letter is in response to your telephone request to Kathryn Camp for further information on NFA's December 7, 1995 and May 28, 1996 submission of proposed amendments to the Guideline for the Disclosure by CPOs and CTAs of "Up Front" Fees and Organizational and Offering Expenses ("the Guideline").

Section A of the Guideline requires CTAs who elect to use dilution tables rather than break-even tables to include all up front fees and charges in their dilution tables, including any organizational and offering expenses incurred by those CTAs. NFA deleted the term "organizational and offering expenses" from the second paragraph of Section A because "organizational and offering expenses" is a term of art which generally applies to CPOs rather than CTAs. Replacing "organizational and offering expenses" with "sales and administrative fees" does not change the character of the fees which must be included in the dilution table but merely reflects that this requirement no longer applies to CPOs.

The second paragraph of Section B of the Guideline provides that a CTA who is acting as an independent advisor to a pool is not required to include the CPO's up front fees and expenses in its own beginning net asset value for purposes of calculating the CTA's own rate-of-return on funds it manages for the CPO. In order to be an independent advisor, the CTA cannot own or control, be owned or controlled by, or be under common ownership or control with the CPO. You asked how NFA will interpret "ownership or control."

NFA will interpret "ownership and control" to be consistent with the well-developed body of law interpreting similar language in Section 2(11) of the Securities Act of 1933. Furthermore, in keeping with a number of CFTC Regulations (e.g., CFTC Regulations 1.3(y) and 3.32(a)(1)) and with Section 16(a) of the Securities Exchange Act of 1934, NFA will always find ownership or control where the CTA , directly or indirectly, is 10% owned by, owns 10% of, or has 10% common ownership with the CPO.

Very truly yours,

Daniel J. Roth
General Counsel

kpc(word\letters\vanwag1)

U.S. COMMODITY FUTURES TRADING COMMISSION
Three Lafayette Centre
1155 21st Street, NW, Washington, DC 20581
Telephone: (202) 418-5000
Facsimile: (202) 418-5521

October 10, 1996

Mr. Daniel J. Roth
General Counsel
National Futures Association
200 West Madison Street
Chicago, Illinois 60606

Re: National Futures Association's Proposed Amendments to Compliance Rule 2-13 -- Notice of Intended Offering and Statement of Terms

Dear Mr. Roth:

By letter dated December 7, 1995, and received December 12, 1995, the National Futures Association ("NFA") submitted to the Commission for its approval, pursuant to Section 17(j) of the Commodity Exchange Act ("Act"), proposed amendments to Compliance Rule 2-13.

By letter dated February 15, 1996, the Division of Trading and Markets ("Division") requested that NFA address various questions regarding its proposed amendments to Compliance Rule 2-13. NFA responded to those questions by letter dated March 6, 1996, and received by the Commission March 8, 1996, and re-submitted a revised version of its proposed amendments to Compliance Rule 2-13 by letter dated May 28, 1996, and received by the Commission on May 31, 1996. NFA staff subsequently clarified various aspects of its proposal in telephone conversations with Commission staff.

Please be advised that on this date the Commission has determined to approve the above-referenced proposed rule amendments pursuant to Section 17(j) of the Act.

Sincerely,

Jean A Webb

Jean A. Webb
Secretary of the Commission

U.S. COMMODITY FUTURES TRADING COMMISSION
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November 22, 1996

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GENERAL COUNSEL'S OFFICE

Mr. Daniel J. Roth
General Counsel
National Futures Association
200 West Madison Street
Chicago, Illinois 60606

Re: National Futures Association's Proposed Amendments to the Guideline for the Disclosure by Commodity Pool Operators and Commodity Trading Advisors of "Up Front" Fees and Organizational and Offering Expenses

Dear Mr. Roth:

By letter dated December 7, 1995, and received December 12, 1995, the National Futures Association ("NFA") submitted to the Commission for its approval, pursuant to Section 17(j) of the Commodity Exchange Act ("Act"), proposed amendments to the Guideline for the Disclosure by Commodity Pool Operators and Commodity Trading Advisors of "Up Front" Fees and Organizational and Offering Expenses ("Up Front Fees Guideline").

By letter dated February 15, 1996, the Division of Trading and Markets requested that NFA address various questions regarding its proposed amendments to the Up Front Fees Guideline in order to further explain and justify the proposal. NFA responded to those questions by letter dated March 6, 1996, and received by the Commission March 8, 1996, and re-submitted a revised version of its proposed amendments by letter dated May 28, 1996, and received by the Commission on May 31, 1996. NFA clarified various aspect of its proposal by letter dated September 17, 1996, and received by the Commission on September 19, 1996

Please be advised that on this date the Commission has determined to approve the NFA's proposed amendments to its Up Front Fees Guideline pursuant to Section 17(j) of the Act.

Sincerely,

Catherine D. Dixon

Catherine D. Dixon
Assistant to the Secretary of the Commission

CFTC Approves Amendments to NFA Compliance Rule 2-13

By letters dated December 7, 1995 and May 28, 1996, NFA submitted to the CFTC for its review and approval proposed amendments to NFA Compliance Rule 2-13. NFA today received notice from the CFTC stating that the Commission on October 10, 1996 approved the amendments as proposed.

NFA Compliance Rule 2-13 was amended to allow CPOs to provide a notice of intended offering and a statement of terms to accredited investors prior to the delivery of a disclosure document, provided that the notice of intended offering and statement of terms clearly state that the offering will be made only by means of a Disclosure Document and include certain limited information.

NATIONAL FUTURES ASSOCIATION
200 W. MADISON ST. • CHICAGO, IL • 60606-3447 • (312) 781-1300

January 15, 1997

The Honorable George Painter
Administrative Law Judge
Commodity Futures Trading Commission
Three Lafayette Centre
1155 21st Street N.W.
Washington, D.C. 20581

Dear Judge Painter:

I really enjoyed speaking with your last week. I've enclosed a copy of the draft Interpretive Notice we discussed and a letter in which we responded to questions posed by Commission staff relating to the responsibilities of FCMs pursuant to the Notice. We anticipate amending the Notice to include the information in the letter.

As I mentioned in our telephone conversation, the purpose of the Interpretive Notice is to clarify the regulatory requirements and tighten the practices relating to the allocation of bunched orders. We know you have a keen interest in these issues and we look forward to receiving your views on the Notice. My direct telephone number is (312) 781-1320. I thank you again for your assistance in this matter.

Sincerely,

Dan Driscoll

Daniel A. Driscoll
Vice President, Compliance

cmc\ltrs\hgp

CFTC Approves Amendments to
NFA's Guideline for the Disclosure by
CPOs and CTAs of "Up Front" Fees
and Organizational and Offering Expenses

By letters dated December 7, 1995 and May 28, 1996, NFA submitted to the CFTC for review and approval proposed amendments to NFA's Guideline for the Disclosure by CPOs and CTAs of "Up Front" Fees and Organizational and Offering Expenses. The Guideline is an interpretation of NFA Compliance Rule 2-13. The amendments eliminate the requirement that CPOs include a dilution table in their disclosure document and give CTAs the option of including either a dilution table or a break-even analysis. Technical amendments were also proposed to reflect recent numbering changes of the Part 4 rules and the use of a performance summary instead of the traditional performance table.

NFA today received notification that on November 22, 1996 the Commission approved the proposed amendments to the Guideline.

NFA NATIONAL FUTURES ASSOCIATION
200 W. MADISON ST. • CHICAGO, IL • 60606-3447 • (312) 781-1300

January 28, 1997

The Honorable George H. Painter
Administrative Law Judge
Office of Proceedings
Commodity Futures Trading Commission
Three Lafayette Centre
1155 21st Street, N.W.
Washington, D.C. 20581

Dear Judge Painter:

Thank you for your letter of January 23 regarding NFA's proposed Interpretive Notice on CFTC Regulation 1.35. Based on your letter, it looks like I did a pretty poor job of describing the proposal during our recent phone conversation.

I have always understood CFTC Regulation 1.35 to require an FCM to receive certain information at the time it accepts an order, including the identity of the accounts for which the trade is being placed and the number of trades each account included in the order its going to receive. The heart of any allocation scam, whether its goal is cheating customers, evading taxes or laundering money, is the ability to provide the required information after the results of the trade are known. I am aware of your concerns that CME Rule 536, despite its restrictions, opens the door to various forms of skullduggery. Our proposal, though, is completely distinct from the CME rule. Far from "castrating" CFTC Regulation 1.35, our proposed Interpretive Notice strictly adheres to the guiding principle behind that rule, requiring all of the necessary information to be provided either contemporaneously with the placement of the order or in advance of the order, through prefiled instructions. In either event, the proposal would not in any way diminish the protections afforded by CFTC Regulation 1.35.

I'm sorry I didn't do a better job of making this point clear. If you would like to discuss any aspect of the proposal further, please do not hesitate to contact me. Thanks again for taking the time to put your thoughts in writing, and I hope to see you again soon.

Sincerely,

Daniel A. Driscoll
Vice President, Compliance

DAD:ckm(ltr\painter)

JAN 27 1997

Mr. Daniel A. Driscoll
Vice President, Compliance
National Futures Association
200 W. Madison St.
Chicago, IL 20581

January 23, 1997

Dear Dan:

It was an unexpected surprise to be given an opportunity to comment on what appears to be a CME rule 536-type proposal. When I think of allocation of futures trades, I think of larceny and fraud. The victim of allocation schemes is not always an innocent customer. In these days of sophisticated trading, the victim is most often the revenue collectors of local, state, and federal tax agencies. Allocation schemes such as the one proposed are designed to benefit tax cheats and money launderers. Hell, if the promoters of this scheme were interested in efficiency, they would be out on the stump trying to modernize the horse-and-buggy trading in the pits.

You are aware, of course, that Regulation 1.35, the target of the proposal, was not the product of this Commission, but rather its predecessor. It took a bit of courage for those old Ag hands to promulgate the rule. Although never enforced, it has been a bone in the throat of those who don't like to be held accountable.

My introduction to allocation schemes was in the Siegel Trading Co., a case that involved tax trading done by one Harold Brady through Joe Siegel's company. I felt rather sorry for Joe. After all, the boys on the Comex had that great switch trade rule, permitting precision-type allocation of trades to accommodate people who hated to pay taxes. Admittedly, all those switch trades and the Brady trades were in contravention of Regulation 1.35. But no one complained. When the IRS got interested in Brady's tax returns Chairman Bill bellowed out, in sum and substance, "Why is the IRS letting people tax trade on our sacred exchanges?" The STC complaint then came out. Remember David Kaufman's famous letter to Sen. Harry Byrd? Technical Corrections Act of 1977, page 450.

There was a tremendous leap forward in fair taxation when a fellow named Robert McIntyre took on the futures industry and persuaded Congress to enact a mark-to-the-market rule. That rule ended a vast amount of tax cheating, always accomplished in violation of regulation 1.35. Allocation didn't go away with this rule, but it put a crimp in the style of those seeking to generate phoney losses for tax purposes.

Allocation used to crop up in a lot of reparations claims, i.e., Winchester-Hardin-Oppenheimer; Quigley v. Dean Witter; Stiller v. Shearson; Parciaseppe v. Shearson; Olson v. Ulmer. The allocation swindle was very simple: enter orders throughout the day, park the executed orders until the close and allocate the better trades to favored accounts. Pretty crude stuff, and not at all the style contemplated by the proposed NFA rule. You would not condone the allocation described in the Quigley and Olson cases.

You are also aware that IBs and CTAs running accounts through a non-member FCMs routinely allocate trades done through an omnibus account. When dealing with turkey customers, the IB or CTA simply arranges for the FCM to report back trades not in accord with the time of execution but rather with the best at the top and the worst at the bottom. And then the customer accounts are lined up with the favored at the top. Total allocation and no audit trail.

You recall that after Parciapsepe went out (Commission opinion) the industry became quite concerned. Thereafter, T & M sent out a letter to the effect that allocation was o.k. provided it was done in a fair and impartial manner. That letter did not, however, void regulation 1.35. Allocation remains unlawful to this very day.

The crooks in the futures industry got upset when Chairman Susan Phillips and Commissioner Hineman began to flesh out the audit trail on futures trades by requiring sequential entry of trades, and the use of non-erasable ink. Stuff like that and rule 1.35 made it hard to take care of a customer wanting to launder money or cheat on taxes.

And then we had the big shocker of the FBI sting. Tony Valukas. Who is the greatest of them all, Valukas or McIntyre? Well, these guys are heroes to me. They gave lot of grief to registrants with larceny in their hearts.

One need go no further than In the Matter of Angelo to find out why the industry craves the right to allocate. In that case, one entity had two accounts with a single FCM. Huge spread trades put on and liquidated within minutes, with losing legs assigned to one account and winning legs to the other. Again, all in violation of rule 1.35. I think you and I know why the trades were made. And if you want a study in methods of unlawful allocation take a look at the ID in the GNP case. There, again, in violation of 1.35.

I believe the allocation scheme promoted by the NFA is designed to aid and assist a privileged class in (1) evading or avoiding taxes or (2) laundering ill gotten gains. It is utter nonsense to argue that a major CTA cannot run a "...dynamic trading program..." without placing bunch orders. With the electronic technology in place today, one can push a single button and place individual orders for scores of accounts in mere seconds. The rule proposed does not call for efficiency. It calls for outright fraud in the ex pit allocation of trades. If an order is placed for an account, it **must** be identified as required by 1.35, and executed in the vaunted "open outcry" method. It is outrageous for the industry to plead for the right to maintain a shelf full of pre-executed trades for allocation to selected accounts on an "as needed" basis. I see this rule as an attempt to create a bucket shop industry to peddle rigged trades for the benefit of fat cat customers. To allocate is to offer a mechanism for tax cheats and money launderers to execute their schemes in the shadow of the free market system.

There is some stuff in the proposed rule regarding give ups. From my vantage point, give ups provide cover for those who do not wish to be held responsible for the time and manner of trade execution. Years ago a fellow named Burr wrote me a four page piece on give ups, and it was a revelation. Can't find it now. But be assured that a "give up" does not, in my mind, allow for violation of 1.35.

One last comment: you note in your cover letter that the purpose is to "... clarify the regulatory requirements and tighten the practices relating to the allocation of bunched orders." The truth, Dan, is that "bunch" orders are plain damned illegal, and have been illegal since at least 1971. Our purpose is not to clarify continuing corruption. It is to eliminate corruption. I sure hope you agree with me.

Well, on balance I am opposed to this effort to castrate rule 1.35 and I am opposed to rigged trading through ex-pit trade allocation. This proposal is more outlandish than the infomercials on "ab" devices and options trading that we see on late night television. Should the proposal be published for comment I will endeavor to provide a more reasoned response.

Sincerely,

George H. Painter

p.s. And Dan, I do not for an instant hold you responsible for this proposal. I think someone with evil in his heart dreamed this up.

U.S. COMMODITY FUTURES TRADING COMMISSION
Three Lafayette Centre
1155 21st Street, NW, Washington, DC 20581

RECEIVED
FEB 7 1997

February 4, 1997

Mr. Daniel A. Driscoll
Vice President, Compliance
National Futures Association
200 W. Madison St.
Chicago, IL 60606-3447

Dear Dan:

Your kind letter of January 28 is appreciated, particularly as it lacks the hyperbole and vehemence that permeated my letter of January 23. To paraphrase the pond man, any effort to weaken 1.35 does try my soul. The rule is right. It leaves no wiggle room for ex-pit allocation. I truly hope that efforts to dilute its purpose will fail.

Following the sting operation, a number of young men went to jail for bucketing customer orders. These young men "allocated" trades to their account, and others to customer accounts. I view the allocation of trades ex-pit as a form of bucketing. There is no justification for such a practice. In fact, there is no justification for placing unidentified orders through omnibus accounts, or uinidentified orders through a non-member FCM.

It is unlikely that I can convert you to my way of thinking. I have made no headway with some of my other friends. Nevertheless, should you be in the city and find time for lunch, I would truly enjoy the opportunity to reminisce over the good old days. Also, best regards from Charles Conrad, who holds you in high esteem. We had lunch at Blackie's this day.

Sincerely,

George H. Painter

NFA NATIONAL FUTURES ASSOCIATION
200 W. MADISON ST. • CHICAGO, IL • 60606-3447 • (312) 781-1300

April 18, 1997

Ms. Jean A. Webb
Secretariat
Commodity Futures Trading Commission
Three Lafayette Centre
1155 21st Street, N.W.
Washington, D.C. 20581

Re: National Futures Association: Resubmission of the Proposed Interpretive Notice Relating to the Allocation of Block Orders for Multiple Accounts

Dear Ms. Webb:

By letter dated December 7, 1995, National Futures Association ("NFA") submitted to the Commodity Futures Trading Commission ("Commission" or "CFTC") for its review and approval the proposed adoption of an Interpretive Notice Relating to the Allocation of Block Orders for Multiple Accounts. NFA hereby withdraws that submission and resubmits the proposal pursuant to Section 17(j) of the Commodity Exchange Act, as amended. The proposal contained herein was approved by NFA's Board of Directors ("Board") on February 20, 1997. NFA respectfully requests Commission review and approval of the proposed Interpretive Notice.

PROPOSED ADOPTION OF AN INTERPRETIVE NOTICE RELATING TO THE ALLOCATION OF BLOCK ORDERS FOR MULTIPLE ACCOUNTS
(resubmitted to read as follows)

NFA COMPLIANCE RULE 2-10

INTERPRETIVE NOTICE RELATING TO THE ALLOCATION OF BLOCK ORDERS FOR MULTIPLE ACCOUNTS

CFTC Regulation 1.35, which NFA Compliance Rule 2-10 adopts by reference, requires that each FCM receiving a customer order immediately prepare a written record of the order which includes an appropriate account identification. NFA Compliance Rule 2-4 requires CTA Members to provide FCMs with that required information. The purpose of the regulation is to prevent various forms of customer abuse, such as fraudulent allocation of trades, by providing an adequate audit trail which allows customer orders to be tracked at every step of the order processing system. Since this regulation was originally adopted, however, there have been dramatic changes in the way business is done. With the explosive growth of the managed funds business and the increasing use of "give-up" agreements, it is not at all uncommon for some CTAs to place block orders for hundreds of accounts on markets around the world, with orders executed by one or more FCMs and cleared by other FCMs. How the basic requirements of CFTC Regulation 1.35 apply to block orders for multiple accounts ("block or bunched order") has been the source of considerable difficulty and confusion. While this Notice does not attempt to address all of the issues which can arise in this context, it does provide guidance on commonly recurring questions.

With respect to block orders, CFTC Regulation 1.35 has been interpreted to require that, at or before the time the order is placed, the FCM must be provided with information which identifies the accounts included in the block order and which specifies the number of contracts to be allotted to each account. In most instances, a CTA can verbally provide all of that information contemporaneously with the placement of the order. Some of the time, however, this is not practical. Verbal transmission of numerous account numbers and allocation information could result in price slippage in filling block market orders. Most CTAs can deal with this problem by pre-filing with the FCM standing instructions which contain all of the necessary information.

For a limited number of larger and more sophisticated CTAs, however, pre-filing standing instructions may not be practicable either. For these CTAs, although their basic allocation methodology does not change, the specific allocation instructions produced by the methodology may change on a daily basis. For example, a large CTA with a dynamic trading program may regularly change its order size based upon market volatility and historical price data. Certainly, if a CTA changes its order size, then the precise number of contracts allocated to each account within the CTA's trading program will also change. Other factors could cause regular changes to a CTA's order size and/or allocation breakdowns such as the number of accounts which open and close and any additions and withdrawals made in existing accounts. In the above instances, although the specific application of a CTA's allocation methodology to the universe of its accounts may cause allocation adjustments, the allocation methodology itself remains constant. Because the methodology must meet the standards of this Notice, it must be designed to provide non-preferential treatment for all accounts. Though these CTAs could provide the allocation information to their FCMs in advance of each order, this information could disclose their trading strategies, which they are obviously reluctant to do.

In general, then, there are two alternatives to the verbal filing of all account identification data contemporaneously with order placement:

1) pre-filing of instructions for identification of accounts included in block orders and the allocation of executed block orders to accounts; and

2) under the stringent requirements described below, the contemporaneous filing of allocation instructions via electronic transmission.

This Interpretive Notice clarifies how either approach can be implemented consistent with the requirements of CFTC Regulation 1.35.

PRE-FILING OF ALLOCATION INSTRUCTIONS

Allocation instructions for trades made through block orders for multiple accounts must deal with two separate issues. The first, which arises in all such orders, involves the question of how the total number of contracts should be allocated to the various accounts included in the block order. The second involves the allocation of split or partial fills. For example, a CTA may place a block order of 100 contracts for multiple accounts. In many instances, however, a market order for 100 contracts may be filled at a number of different prices. Similarly, if an order is to be filled at a particular price, the FCM may be able to execute some but not all of the 100 lot order. In either example, the question arises of how the different prices or the contracts in the partial fill should be allocated among the accounts included in the block order.

The same set of core principles govern the procedures to be used in handling both of these issues. Any procedure for the general allocation of trades or the allocation of split and partial fills must be:

- designed to meet the overriding regulatory objective that allocations are non-preferential, such that no account or group of accounts receive consistently favorable or unfavorable treatment;

- sufficiently objective and specific that the appropriate allocation for any given trade can be verified in any audit by NFA, an exchange DSRO, the CFTC or the FCM's and CTA's own accountants; and

- consistently applied by the Member firm.

In performing audits, we have noted that Members employ a wide variety of methods to allocate split and partial fills, some of which satisfy the standards stated above and some of which do not. The following examples of procedures for the allocation of split and partial fills generally satisfy the standards stated above.

Example #1 - Rotation of Accounts

One basic allocation procedure involves a rotation of accounts on a regular cycle, usually daily or weekly, which receive the most favorable fills. For example, if a firm has 100 accounts trading a particular trading program, in the first phase of the cycle, Account #1 receives the best fill, Account #2 the second best, etc. In phase 2 of the cycle, Account #2 receives the best fill and Account #1 moves to the end of the line and receives the least favorable fill.

Example #2 - Random Allocation

Some firms prepare on a daily basis a computer generated random order of accounts and allocate the best price to the first account on the list and the worst to the last. This method would satisfy the standards stated above.

Example #3 - Highest Prices to the Highest Account Numbers

Some firms rank accounts in order of their account numbers and then allocate the highest fill prices to the accounts with the highest account numbers. Any advantage the higher numbered accounts enjoy on the sell order are theoretically offset by the disadvantage on the buy orders. Although under certain market conditions this may not always be true, the method generally complies with the standards.

Example #4 - Average Price and Quantity

With regard to split and partial fills, allocations made pursuant to exchange rules which provide for the allocation of average prices and quantities in block orders for multiple accounts would, of course, be acceptable. In addition, certain firms may have internal programs which calculate the average price for each block order and allocate the actual fill prices among the accounts included in the order to approximate, as closely as possible, the average fill price. These internal programs must specifically satisfy the standards stated above and be documented by the Member firm.

Though the examples cited above are the ones NFA most commonly sees in audits, others may offer comparable treatment. We would also note that 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. In addition, certain variations of these basic methods would not satisfy those requirements. For example, it would not be acceptable for the CTA to deviate from the regular rotation to accommodate an account whose performance is lagging behind others in the same program. This would inject the CTA's subjective judgment into the process, would render the allocation impossible to duplicate in the audit process and would open the potential for customer abuse.

One related issue which has generated some confusion is whether the responsibility for the allocation of split and partial fills rests with the CTA or with the FCM. The CTA certainly has the sole responsibility for ensuring that the procedures are appropriate in light of its approach to trading. With respect to the actual implementation of the procedures, since the CTA is directing the trading in the accounts, the responsibility for allocating split and partial fills among the accounts should rest with the CTA. However, there is nothing under NFA rules to preclude an FCM from agreeing to undertake this responsibility, whether it clears or executes the trades, pursuant to either its own procedures or to those supplied by the CTA. Any division of responsibilities agreed to by the FCM and CTA should be clearly documented.

There is also a good deal of confusion on how the basic principles of CFTC Regulation 1.35 apply to block orders executed on a "give-up" basis, a process which was essentially unknown when Regulation 1.35 was originally adopted. Subject to exchange rules, in any given block order there may be multiple executing FCMs, multiple clearing FCMs or multiple FCMs serving each of these functions. The exact form of customer identification which the FCM must receive from the CTA under Regulation 1.35 may vary depending on the FCM's role in filling the order. Essentially, each FCM must receive sufficient information to allow it to perform its function. For executing FCMs, this includes, at a minimum, the number of contracts to be given up to each clearing FCM and instructions for allocation of split and partial fills among those FCMs. Information concerning the number of contracts to be allocated to each account included in the block order must be provided to the FCM which will carry out those instructions, which, in most cases, will be the FCM clearing the accounts. All of this information must be provided at or before the time the order is placed and could be provided by pre-filing a set of instructions. If the pre-filed instructions for the general allocation or the allocation of split and partial fills meet the standards set forth in this Notice, then the clerical task of implementing the instructions could be performed by either the FCM or the CTA.

If that clerical function is performed by the CTA, this does not suggest that the FCM is relieved of any further responsibility. The 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 (e.g., the CFTC or the NFA or its DSRO). Obviously, whether an FCM has such notice depends upon the information that the FCM has or should have, which, in turn, is based upon the FCM's role in the executing and clearing process. For example, an FCM that both executes and clears an entire block order will possess more information than an FCM that executes or clears only a portion of an order. In order to fulfill its duties, an FCM at any level of the process should implement appropriate compliance measures. For example, an FCM may choose to spot check the allocations made to its customer accounts for conformity with the prefiled instructions it has received from the CTA and/or review the performance of accounts being traded pursuant to the same trading program.

CONTEMPORANEOUS FILING OF INSTRUCTIONS VIA ELECTRONIC TRANSMISSION

Instructions for the allocation of contracts to accounts included in a block order can also be given at the time the CTA places the trade. NFA notes, however, that as a general rule allocation procedures for split and partial fills should be pre-filed with the appropriate FCM. For instructions on the number of contracts to be assigned to each account in the block order, many CTAs simply provide the necessary allocation information by phone when they call in the block order. For certain CTAs, however, providing allocation instructions verbally when the block order is placed may not be a practicable option. These CTAs may have hundreds of accounts included in the block order and providing detailed allocation information by phone may be extremely time consuming. Delaying the execution of the order while that process drags on might ultimately harm customers through market price slippage. For most of these CTAs, the prefiling of instructions provides an adequate alternative. However, for a limited number of CTAs, it may not be practicable to pre-file with the FCM a standing set of allocation instructions. The trading programs used by these CTAs are complex and dynamic. Given the fine tuning adjustments that are made on a daily basis, the exact number of contracts these CTAs allocate to any given account may vary from one day to the next, and may make the prefiling of instructions impracticable.

Under these circumstances, one way the CTA may provide the account identification information required under CFTC Regulation 1.35 would be to send the FCM, by facsimile or other form of electronic transmission, the breakdown of contracts to be assigned to each account included in the block order. The CTA would have to begin to send that information at the time the order is placed. Given the possibility of busy signals, paper jams and other limitations of electronic transmissions, there may be momentary delays in the completion of the transmission. Such delays should be neither commonplace nor lengthy, and the CTA should maintain appropriate documentation whenever such delays occur. When those delays do occur, however, CFTC Regulation 1.35 does not necessarily require the FCM to delay execution of the order until the electronic transmission of the allocation information is completed. To avoid delays in execution due to such transmission difficulties, the CTA must have provided the FCM with a written certification that:

(1) the CTA will begin the transmission to the FCM of the allocation breakdown contemporaneously with the placement of the order and will maintain appropriate documentation regarding any delays experienced in such transmission;

(2) prior to the placement of an order, the CTA has also generated a non-preferential allocation breakdown for each order which has been computer time-stamped indicating the date on which the order is to be placed and the date and time the allocation breakdown was printed;

(3) the CTA maintains with either their executing or clearing FCMs a complete list of all accounts traded by the CTA, by trading program if applicable;

(4) if a bunched order does not include all accounts within a particular trading program, then prior to the execution of the order these CTAs will identify for their FCMs the accounts which are included, by account identifier or designation;

(5) on a daily basis, these CTAs confirm that all their accounts have the correct allocation of contracts; and

(6) at least once a month, these CTAs analyze each trading program to ensure that the allocation method has been fair and equitable. If divergent performance results exist over time, then such results must be shown to be attributable to factors other than the CTA's trade allocation or execution procedures. Additionally, a CTA must document its internal audit procedures and the results of its monthly analysis and maintain these audit procedures and results as firm records subject to review during an NFA audit.

An FCM which relies in good faith on the above certification would be deemed to be in compliance with CFTC Regulation 1.35. The CTA must also file a copy of that certification with NFA at least thirty days prior to implementing these procedures. This time period will provide NFA with an opportunity to review and verify the information contained in the certification.

For most block orders, the pre-filing of allocation instructions is the most practicable and preferred course of action. The procedure described herein relating to the contemporaneous filing of instructions via electronic transmission is an alternative available to those relatively few CTAs that can demonstrate a need for this alternative and meet the requirements of the certification. Each CTA availing itself of this alternative must not only adhere to the requirements of this Notice, but also demonstrate on a continuing basis to the appropriate regulator or self-regulator both its need to use this alternative and that the information in the certification is correct. If a CTA utilizes this alternative, it must adhere to this Notice's requirements or may face disciplinary action for its failure to do so. If any Member has questions concerning how this Interpretive Notice would apply to its operations, please contact NFA's Compliance Department.

EXPLANATION OF THE PROPOSED INTERPRETIVE NOTICE

Since NFA's December 7, 1995 submission of the proposed adoption of an Interpretive Notice Relating to the Allocation of Block Orders for Multiple Accounts, NFA staff has had several meetings with Commission staff to discuss the Interpretive Notice. These discussions primarily focused on the section of the Interpretive Notice that allows certain CTAs to transmit allocation instructions to clearing FCMs electronically, contemporaneously with the placement of the order. Commission staff subsequently proposed a number of technical amendments which NFA incorporated into the proposed Interpretive Notice. They include the following:

- a more complete explanation as to why it is impractical for a limited number of larger and more sophisticated CTAs to prefile standing allocation instructions;

- an explanation of the average price and quantity procedure for allocating split and partial fills; and

- a more complete explanation as to why the procedures relating to the contemporaneous filing of instructions via electronic transmission are meant for relatively few CTAs.

In addition to the aforementioned technical amendments, Commission staff also requested clarification relating to an FCM's duty to its customers in the event that a CTA prefiles allocation instructions with the FCM and the CTA itself provides the FCM with specific information on how the prefiled instructions apply to a particular order. In response to the Commission's request, NFA added language to the proposed Interpretive Notice to clarify that an 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. The proposed Interpretive Notice specifically states that 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 (e.g., the CFTC or NFA or its DSRO). Obviously, whether an FCM has such notice depends upon the information that the FCM has or should have, which, in turn, is based upon the FCM's role in the executing and clearing process.

NFA respectfully requests that the Commission review and approve the proposed Interpretive Notice contained in this submission and requests that it be declared effective upon Commission approval.

Sincerely,

Daniel J. Roth

Daniel J. Roth
General Counsel

cc: Chairman Brooksley Born
Commissioner Barbara Pedersen Holum
Commissioner Joseph B. Dial
Commissioner John E. Tull, Jr.
Commissioner David D. Spears
Andrea M. Corcoran, Esq.
Geoffrey Aronow, Esq.
Alan L. Seifert, Esq.
Susan C. Ervin, Esq.
Lawrence B. Patent, Esq.
David Van Wagner, Esq.

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NATIONAL FUTURES ASSOCIATION
200 W. MADISON ST. • CHICAGO, IL • 60606-3447 • (312) 781-1300

June 4, 1997

Ms. Jean A. Webb
Secretariat
Commodity Futures Trading Commission
1155 21st Street, N.W.
Washington, DC 20581

Re: The Commodity Futures Trading Commission's Notice of Interpretation and Approval Order Relating to Bunched Orders and Account Identification

Dear Ms. Webb:

National Futures Association ("NFA") respectfully submits the following comments in response to a release issued by the Commodity Futures Trading Commission ("Commission or CFTC") on May 9, 1997.[1] That release requested comments on the Commission's notice of interpretation and approval order relating to bunched orders and account identification. That release also expressly withdraws proposed Regulation 1.35 (a-1)(5)[2], which required, in part, that if certain entities bunch orders with customer orders then the customer must receive a better or equal fill price. NFA submits this letter in strong support of this notice of interpretation and approval order.

CFTC Regulation 1.35 requires that each futures commission merchant ("FCM") receiving a customer order immediately prepare a written record of the order which includes an appropriate account identification. The purpose of this regulation is to prevent various forms of customer abuse, such as the fraudulent allocation of trades, by providing an adequate audit trail which allows customer orders to be tracked at every step of the order processing system. Since this regulation was originally adopted, however, there have been dramatic changes in the way business is done. With the explosive growth of the managed funds business and the increasing use of "give-up" agreements, it is not at all uncommon for some commodity trading advisors ("CTA") to place bunched orders for hundreds of accounts on markets around the world, with orders executed by one or more FCMs and cleared by other FCMs. How the basic requirements of CFTC Regulation 1.35

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1 62 Fed. Reg. 25470 (1997)
2 58 Fed. Reg. 26270 (1993)

apply to bunched orders for multiple accounts has been the source of considerable difficulty and confusion.

With respect to bunched orders, the Commission has previously interpreted Regulation 1.35 to require that, at or before the time the order is placed, the FCM must be provided with information which identifies the accounts included in the bunched order and which specifies the number of contracts to be allotted to each account. In most instances, a CTA can verbally provide all of that information contemporaneously with the placement of the order. Some of the time, however, this is not practical. Verbal transmission of numerous account numbers and allocation information could easily result in significant price slippage in filling bunched market orders. Most CTAs can deal with this problem by pre-filing with the FCM standing instructions which contain all of the necessary information.

For a limited number of larger and more sophisticated CTAs, however, pre-filing standing instructions is not practical either. For these CTAs, although their basic allocation methodology does not change, the specific allocation instructions produced by the methodology may change on a daily basis. For example, a large CTA with a dynamic trading program may regularly change its order size based upon market volatility and historical price data. Certainly, if a CTA changes its order size, then the precise number of contracts allocated to each account within the CTA's trading program will also change. Other factors could cause regular changes to a CTA's order size and/or allocation breakdowns such as the number of accounts which open and close and any additions and withdrawals made in existing accounts. In the above instances, although the specific application of a CTA's allocation methodology to the universe of its accounts may cause allocation adjustments, the allocation methodology itself remains constant. Though these CTAs could provide allocation information to their FCMs in advance of each order, this information could disclose their trading strategies, which they are obviously reluctant to do.

NFA staff has discussed the aforementioned difficulties experienced by certain CTAs with a Special Committee which included representatives of the FCM, CTA and exchange communities. In addition, we issued a notice requesting Member comments and discussed the issues with the FCM, IB and CPO/CTA Advisory Committees.

NFA's Interpretive Notice

NFA's proposed Interpretive Notice to Compliance Rule 2-10 Relating to the Allocation of Block Orders for Multiple Accounts discusses two alternative methods to the verbal filing of account identification and allocation information contemporaneously with order placement. Pursuant to the first alternative method, a CTA may provide its FCM with a pre-filed set of instructions identifying the accounts included in bunched orders and the allocation of contracts to accounts included in executed bunched orders. Pursuant to the second alternative, under certain specified and stringent circumstances, a CTA may send its FCM, by facsimile or other form of electronic transmission, instructions relating to account identification and the allocation of contracts included in a bunched order contemporaneously with the placement of an order. NFA's proposed Interpretive Notice also makes clear that prefiled or contemporaneous instructions must include a methodology to allocate split and partial fills and it clarifies the application of these procedures to "give-up" arrangements.

NFA believes that the order execution procedures set forth in its proposed Interpretive Notice are consistent with the requirements of Commission Regulation 1.35 and, at the same time, provide needed guidance to NFA Member firms relating to account identification and allocation procedures. Therefore, NFA strongly encourages the Commission to adopt NFA's proposed Interpretive Notice to Compliance Rule 2-10 Relating to the Allocation of Block Orders for Multiple Accounts.

Commission Guidance

In its Federal Register release, the Commission also sets forth specific guidance relating to the handling of bunched orders by Commission registrants (i.e. floor brokers), who are neither NFA Members nor under the supervision of an NFA Member. After reviewing this guidance, NFA believes that comparable regulatory requirements exist, relating to Regulation 1.35's account identification requirements, for both NFA Member firms and floor brokers receiving customer orders. Additionally, NFA is prepared to accept pre-filed allocation instructions from CTAs seeking to comply with the Commission guidance.

In conclusion, NFA again expresses strong support for the Commission's notice of interpretation and approval order relating to bunched orders and account identification. At this time, NFA also wishes to recognize the cooperative effort of the

Commission in addressing these issues. As always, NFA encourages the Commission to give serious consideration to the industry's comments regarding both NFA's proposed Interpretive Notice and the Commission guidance set forth in the approval order.

Respectfully Submitted,

Daniel J. Roth
General Counsel

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c. By revising the phrase "N-Methyl-3-piperidonol" to read "N-Methyl-3-piperidinol" in paragraph (k)(26).

94. Section 770.3(c)(1) is amended:

a. By revising the phrase "is subject to the EAR is the same manner" to read "is subject to the EAR in the same manner"; and

b. By revising the phrase "described at § 732.4 of the EAR." to read "described in § 734.4 of the EAR.".

95. Section 770.3 is further amended:

a. By revising the phrase "described at § 732.4 of the EAR." to read "described in § 734.4 of the EAR.", in paragraph (c)(2);

b. By revising paragraph (d)(1)(i)(B);

c. By revising paragraph (d)(1)(ii); and

d. By revising paragraph (d)(2)(ii), as follows:

§ 770.3 Interpretations related to exports of technology and software to destinations in Country Group D:1.

* * * * *

(d) * * *

(1) * * *

(i) * * *

(B) Can we send an engineer (with knowledge and experience) to the customer site to perform the installation or repair, under the provisions of License Exception TSU for operation technology and software described in § 740.13(a) of the EAR, if it is understood that he is restricted by our normal business practices to performing the work without imparting the knowledge or technology to the customer personnel?

(ii) *Answer 1.* Export of technology includes release of U.S.-origin data in a foreign country, and "release" includes "application to situations abroad of personal knowledge or technical experience acquired in the United States." As the release of technology in the circumstances described here would exceed that permitted under the License Exception TSU for operation technology and software described in § 740.13(a) of the EAR, a license would be required even though the technician could apply the data without disclosing it to the customer.

(2) * * *

(ii) *Answer 2.* (A) Provided that this is your normal training, and involves technology contained in your manuals and standard instructions for the exported equipment, and meets the other requirements of License Exception TSU for operation technology and software described in § 740.13(a), the training may be provided within the limits of those provisions of License Exception TSU. The location of the training is not significant, as the export occurs at the time and place of the actual transfer or imparting of the technology to the customer's engineers.

(B) Any training beyond that covered under the provisions of License Exception TSU for operation technology and software described in § 740.13(a), but specifically represented in your license application as required for this customer installation, and in fact authorized on the face of the license or a separate technology license, may not be undertaken while the license is suspended or revoked.

PART 772—[AMENDED]

96. Part 772 is amended:

a. By revising the citation reference "§ 748.4" to read § 748.5" in the definition for "Applicant";

b. By revising the phrase "perform (a) specific function" to read "perform a specific function" in the definition for "Assembly";

c. By revising the definition for "CCL Group";

d. By revising the definition for "Category";

e. By revising the phrase "application for International Import Certificate; International Import Certificate; Delivery Verification Certificate" to read "application for International Import Certificate; Delivery Verification Certificate" in the definition for "Export control document";

f–g. By revising the definition of "Required";

h. By revising the phrase "Mixed sequence manipulation" to read "Fixed sequence manipulation" as it appears in paragraph (b) to the Note under the definition for "Robot";

i. By revising the phrase "commodities, Software, technology" to read "commodities, software, technology" in the definition for "Subject to the EAR";

j. By revising the phrase "by low of elongation" to read "by low elongation" in the definition for "Superplastic forming"; and

k. By revising the citation reference "§ 748.4(b)(5)" to read "§ 748.5(e)", in the definition for "Ultimate Consignee".

PART 772—DEFINITIONS OF TERMS

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CCL Group. The Commerce Control List (CCL) is divided into 10 categories. Each category is subdivided into five groups, designated by the letters A through E: (A) Equipment, assemblies and components; (B) Test, inspection and production equipment; (C) Materials; (D) Software; and (E) Technology. See § 738.2(b) of the EAR.

* * * * *

Category. The Commerce Control List (CCL) is divided into ten categories: (0) Nuclear Materials, Facilities and Equipment, and Miscellaneous; (1) Materials, Chemicals, "Microorganisms", and Toxins; (2) Materials Processing; (3) Electronics Design, Development and Production; (4) Computers; (5) Telecommunications and Information Security; (6) Sensors; (7) Navigation and Avionics; (8) Marine; (9) Propulsion Systems, Space Vehicles, and Related Equipment. See § 738.2(a) of the EAR.

* * * * *

"Required". As applied to "technology" or "software", refers to only that portion of "technology" or "software" which is peculiarly responsible for achieving or extending the controlled performance levels, characteristics or functions. Such "required" "technology" or "software" may be shared by different products. For example, assume product "X" is controlled if it operates at or above 400 MHz and is not controlled if it operates below 400 MHz. If production technologies "A", "B", and "C" allow production at no more than 399 MHz, then technologies "A", "B", and "C" are not "required" to produce the controlled product "X". If technologies "A", "B", "C", "D", and "E" are used together, a manufacturer can produce product "X" that does not operate at or above 400 MHz. In this example, technologies "D" and "E" are "required" to make the controlled product and are themselves controlled under the General Technology Note. (See the General Technology Note.)

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Dated: May 1, 1997.

Sue E. Eckert,

Assistant Secretary for Export Administration.

[FR Doc. 97–11727 Filed 5–8–97; 8:45 am]

BILLING CODE 3510–33–P

COMMODITY FUTURES TRADING COMMISSION

17 CFR Part 1

Bunched Orders and Account Identification

AGENCY: Commodity Futures Trading Commission.

ACTION: Notice of Interpretation and Approval Order.

SUMMARY: The Commodity Futures Trading Commission ("Commission") hereby is issuing an Interpretation regarding the account identification requirement of Commission Regulation

1.35(a–1)(2)(i) as it pertains to the practice of combining orders for different accounts into a single order for placement and execution, *i.e.*, "block" or "bunched" orders. The Commission simultaneously is issuing an Order approving the National Futures Association ("NFA") Interpretive Notice to NFA Compliance Rule 2–10 Relating to the Allocation of Block Orders for Multiple Accounts ("NFA Notice").[1] This Interpretation provides that, with respect to bunched orders, compliance with the guidance provided in the NFA Notice, incorporated herein, and with the Commission guidance provided in this Interpretation, will be deemed by the Commission to be compliance with the account identification requirement of the above-cited regulation. The Commission also is providing an opportunity for comment prior to this Interpretation and Approval Order becoming effective.

DATES: This Interpretation and Approval Order, subject to the Commission's consideration of any comments received, shall become effective simultaneously on June 9, 1997.

ADDRESSES: Interested person should submit their views and comments to Jean A. Webb, Secretary, Commodity Futures Trading Commission, Three Lafayette Centre, 1155 21st St., NW., Washington, DC 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 bunched orders and account identification.

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

SUPPLEMENTARY INFORMATION:

I. Introduction

This Interpretation sets forth certain account documentation procedures under which bunched orders may be placed, recorded, executed, "given up" to multiple clearing firms, where applicable, and allocated to customer accounts, which the Commission will deem as sufficient to satisfy the account identification requirement of Regulation 1.35(a–1)(2)(i). By this Approval Order, the Commission, pursuant to Section 17(j) of the Commodity Exchange Act, is approving the NFA Notice. The Commission also is setting forth additional guidance under which bunched orders may be handled, to include situations where certain of the NFA procedures may not be applicable in that they do not apply to registrants who are not members of the NFA or under the supervision of NFA members.[2]

The Commission's issuance of this Interpretation and Approval Order is based on its understanding that (1) commodity trading advisors ("CTA"), futures commission merchants ("FCM"), introducing brokers ("IB"), consistent with their responsibilities hereunder, will maintain documentation sufficient to demonstrate that the procedures authorized hereby are in fact followed, and (2) affected registrants, exchanges and the NFA will have effective systems in place that are used to monitor compliance and that appropriate procedures will be in place to address apparent noncompliance. In this connection, Commission staff recently has reviewed relevant audit and compliance procedures at the NFA and exchanges with respect to account identification for bunched orders. Commission staff also, on an ongoing basis, has encouraged the implementation of audit enhancements to address the types of allocation abuses observed in connection with exchange and Commission investigations regarding preferential allocation and other forms of allocation fraud.

In general, as specified herein with respect to bunched orders, the floor order account identification requirement of Commission Regulation 1.35(a–1)(2)(i) may be met by prefiling the appropriate order allocation procedures with a registrant clearing or executing the trades, the NFA or an exchange. That regulation's account identification requirement also may be met by the contemporaneous transmission of such allocation instructions with the order to a registrant clearing or executing the trades, either verbally or, consistent with the methodology described in the NFA Notice, electronically. These prefiled procedures or contemporaneous instructions also must include a methodology to allocate to those accounts orders that may be filled at multiple prices ("split fills") or at less than specified quantities ("partial fills") and, where applicable, to allocate give ups to multiple clearing firms, including a methodology to allocate split and partial fills among those clearing firms. CTAs, FCMs, IBs, their respective associated persons ("AP"), and FBs, as applicable, who do not identify the ultimate customer(s) and appropriate quantity on a floor order must satisfy the standards set forth in the NFA Notice and the Commission guidance provided herein to be in compliance with Commission Regulation 1.35(a–1)(2)(i). Compliance with the express terms of Regulation 1.35(a–1)(2)(i) will continue to be required in all cases where the procedures referenced in this Interpretation are not applicable or are not followed.

II. Background

Commission Regulation 1.35(a–1)(1) requires that each FCM and each IB receiving a customer order immediately prepare a written record of the order which includes certain account identification. 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 the form of a written record also immediately prepare a written record of such order, including certain account identification. Under that rule, the floor order must include the account number for the ultimate customer for whom the order is placed or an identifying code which is directly linked to that specific customer account. This requirement has existed since Regulation 1.35(a–1)(2) became effective March 24, 1972.[3] Since this regulation was adopted, there have been changes in the manner in which orders are placed, executed and cleared on the futures markets that reflect changes in the manner of doing business and in the types of entities using these markets. With the growth of managed funds business, in which multiple accounts are advised by one adviser using one or more trading strategies, the practice of bunching multiple orders for different accounts into a single order for placement and execution has increased dramatically. In addition, the unbundling of clearing and execution services has resulted in the increasingly common use of give up arrangements, whereby orders are executed by one or more FCMs and given up for clearing to other FCMs. While the CTA selects the executing FCM, the CTA's customers may select different FCMs for clearing purposes.

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[1] The NFA Notice is published herein as paragraph III to this Interpretation and Approval Order.

[2] The interpretation reflected herein pertains only to bunched orders as defined in this Interpretation or the NFA Notice. All other customer orders placed for execution must be documented in accordance with the express terms of Regulation 1.35(a–1)(2)(1) and applicable exchange rules.

[3] 37 FR 3802 (February 23, 1972). Regulation 1.35(a–1)(2) was amended effective August 30, 1993 and was redesignated as 1.35(a–1)(2)(i). 58 FR 31162 (June 1, 1993). The requirement to include customer account identification on the floor order remained unchanged.

Previously, to accommodate these changes in industry practice, Commission staff interpreted Regulation 1.35(a–1)(2)(i) to permit the placement and execution of bunched orders provided that the person placing the bunched order provided at the time of entry a single series designation that identified all accounts included in the bunched order and a predetermined allocation formula. That interpretation required that the allocation formula be provided to the FCM prior to or contemporaneously with the placement of the bunched order, specify by account number those accounts to which it would apply, specify the number of contracts to be allocated to each account, and be designed to provide fair and equitable treatment of the accounts such that no account or group of accounts received consistently favorable or unfavorable treatment. That interpretation of Regulation 1.35(a–1)(2)(i) consistently has been provided in response to specific inquiries and, in recognition that written regulatory guidance in this area may be necessary, was published in the **Federal Register** as paragraph (5) of a proposed amendment to Regulation 1.35(a–1).[4] In issuing this Interpretation, the Commission expressly is adopting procedures consistent with the staff interpretation as clarified herein and withdrawing proposed Regulation 1.35(a–1)(5).

III. The NFA Notice

The NFA Notice addresses three primary issues: (1) The manner and timing of the identification of the allocation formula; (2) principles that govern the allocation of trades; and (3) bunched orders executed on a give up basis, and reads in full as follows:

NFA Compliance Rule 2–10; Interpretive Notice Relating to the Allocation of Block Orders for Multiple Accounts

CFTC Regulation 1.35, which NFA Compliance Rule 2–10 adopts by reference, requires that each FCM receiving a customer order immediately prepare a written record of the order which includes an appropriate account identification. NFA Compliance Rule 2–4 requires CTA Members to provide FCMs with that required information. The purpose of the regulation is to prevent various forms of customer abuse, such a fraudulent allocation of trades, by providing an adequate audit trail which allows customer orders to be tracked at every step of the order processing system. Since this regulation was originally adopted, however, there have been dramatic changes in the way business is done. With the explosive growth of the managed funds business and the increasing use of "give-up" agreements, it is not at all uncommon for some CTAs to place block orders for hundreds of accounts on markets around the world, with orders executed by one or more FCMs and cleared by other FCMs. How the basic requirements of CFTC Regulation 1.35 apply to block orders for multiple accounts ("block or bunched order") has been the source of considerable difficulty and confusion. While this Notice does not attempt to address all of the issues which can arise in this context, it does provide guidance on commonly recurring questions.

With respect to block orders, CFTC Regulation 1.35 has been interpreted to require that, at or before the time the order is placed, the FCM must be provided with information which identifies the accounts included in the block order and which specifies the number of contracts to be allotted to each account. In most instances, a CFTA can verbally provide all of that information contemporaneously with the placement of the order. Some of the time, however, this is not practical. Verbal transmission of numerous account numbers and allocation information could result in price slippage in filling block market orders. Most CTAs can deal with this problem by pre-filing with the FCM standing instructions which contain all of the necessary information.

For a limited number of larger and more sophisticated CTAs, however, pre-filing standing instructions may not be practicable either. For these CTAs, although their basic allocation methodology does not change, the specific allocation instructions produced by the methodology may change on a daily basis. For example, a large CTA with a dynamic trading program may regularly change its order size based upon market volatility and historical price data. Certainly, if a CTA changes its order size, then the precise number of contracts allocated to each account within the CTA's trading program will also change. Other factors could cause regular changes to a CTA's order size and/or allocation breakdowns such as the number of accounts which open and close and any additions and withdrawals made in existing accounts. In the above instances, although the specific application of a CTA's allocation methodology to the universe of its accounts may cause allocation adjustments, the allocation methodology itself remains constant. Because the methodology must meet the standards of this Notice, it must be designed to provide non-preferential treatment for all accounts. Though these CTAs could provide the allocation information to their FCMs in advance of each order, this information could disclose their trading strategies, which they are obviously reluctant to do.

In general, then, there are two alternatives to the verbal filing of all account identification data contemporaneously with order placement:

(1) pre-filing of instructions for identification of accounts included in block orders and the allocation of executed block orders to accounts; and

(2) under the stringent requirements described below, the contemporaneous filing of allocation instructions via electronic transmission.

This Interpretive Notice clarifies how either approach can be implemented consistent with the requirements of CFTC Regulation 1.35.

Pre-Filing of Allocation Instructions

Allocation instructions for trades made through block orders for multiple accounts must deal with two separate issues. The first, which arises in all such orders, involves the question of how the total number of contracts should be allocated to the various accounts included in the block order. The second involves the allocation of split or partial fills. For example, a CTA may place a block order of 100 contracts for multiple accounts. In many instances, however, a market order for 100 contracts may be filled at a number of different prices. Similarly, if an order is to be filled at a particular price, the FCM may be able to execute some but not all of the 100 lot order. In either example, the question arises of how the different prices or the contracts in the partial fill should be allocated among the accounts included in the block order.

The same set of core principles govern the procedures to be used in handling both of these issues. Any procedure for the general allocation of trades or the allocation of split and partial fills must be:

- Designed to meet the overriding regulatory objective that allocations are non-preferential, such that no account or group of accounts receive consistently favorable or unfavorable treatment;
- Sufficiently objective and specific that the appropriate allocation for any given trade can be verified in any audit by NFA, an exchange DSRO, the CFTC or the FCM's and CTA's own accountant; and
- Consistently applied by the Member firm.

In performing audits, we have noted that Members employ a wide variety of methods to allocate split and partial fills, some of which satisfy the standards stated above and some of which do not. The following examples of procedures for the allocation of split and partial fills generally satisfy the standards stated above.

Example #1—Rotation of Accounts

One basic allocation procedure involves a rotation of accounts on a regular cycle, usually daily or weekly, which receive the most favorable fills. For example, if a firm has 100 accounts trading a particular trading program, in the first phase of the cycle, Account #1 receives the best fill, Account #2 the second best, etc. In phase 2 of the cycle, Account #2 receives the best fill and Account #1 moves to the end of the line and receives the least favorable fill.

Example #2—Random Allocation

Some firms prepare on a daily basis a computer generated random order of accounts and allocate the best price to the first account on the list and the worst to the last. This method would satisfy the standards stated above.

Example #3—Highest Prices to the Highest Account Numbers

Some firms rank accounts in order of their account numbers and then allocate the highest fill prices to the accounts with the

[4] 58 FR 26270 (May 3, 1993).

highest account numbers. Any advantage the igher numbered accounts enjoy on the sell rder are theoretically offset by the isadvantage on the buy orders. Although under certain market conditions this may not always be true, the method generally complies with the standards.

Example #4—Average Price and Quantity

With regard to split and partial fills, allocations made pursuant to exchange rules which provide for the allocation of average prices and quantities in block orders for multiple accounts would, of course, be acceptable. In addition, certain firms may have internal programs which calculate the average price for each block order and allocate the actual fill prices among the accounts included in the order to approximate, as closely as possible, the average fill price. These internal programs must specifically satisfy the standards stated above and be documented by the Member firm.

Though the examples cited above are the ones NFA most commonly sees in audits, others may offer comparable treatment. We would also note that 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. In addition, certain variations of these basic methods would not satisfy those requirements. For example, it would t be acceptable for the CTA to deviate from regular rotation to accommodate an account whose performance is lagging behind others in the same program. This would inject the CTA's subjective judgment into the process, would render the allocation impossible to duplicate in the audit process and would open the potential for customer abuse.

One related issue which has generated some confusion is whether the responsibility for the allocation of split and partial fills rests with the CTA or with the FCM. The CTA certainly has the sole responsibility for ensuring that the procedures are appropriate in light of its approach to trading. With respect to the actual implementation of the procedures, since the CTA is directing the trading in the accounts, the responsibility for allocating split and partial fills among the accounts should rest with the CTA. However, there is nothing under NFA rules to preclude an FCM from agreeing to undertake this responsibility, whether it clears or executes the trades, pursuant to either its own procedures or to those supplied by the CTA. Any division of responsibilities agreed to by the FCM and CTA should be clearly documented.

There is also good deal of confusion on how the basic principles of CFTC Regulation 1.35 apply to block orders executed on a "give-up" basis, a process which was essentially unknown when Regulation 1.35 was originally adopted. Subject to exchange es, in any given block order there may be ltiple executing FCMs, multiple clearing rCMs or multiple FCMs serving each of these functions. The exact form of customer identification which the FCM must receive from the CTA under Regulation 1.35 may vary depending on the FCM's role in filling the order. Essentially, each FCM must receive sufficient information to allow it to perform its function. For executing FCMs, this includes, at a minimum, the number of contracts to be given up to each clearing FCM and instructions for allocation of split and partial fills among these FCMs. Information concerning the number of contracts to be allocated to each account included in the block order must be provided to the FCM which will carry out those instructions, which, in most cases, will be the FCM clearing the accounts. All of this information must be provided at or before the time the order is placed and could be provided by pre-filing a set of instructions. If the pre-filed instructions for the general allocation or the allocation of split and partial fills meet the standards set forth in this Notice, then the clerical task of implementing the instructions could be performed by either the FCM or the CTA.

If that clerical function is performed by the CTA, this does not suggest that the FCM is relieved of any further responsibility. The 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 (e.g., the CFTC or the NFA or its DSRO). Obviously, whether an FCM has such notice depends upon the information that the FCM has or should have, which, in turn, is based upon the FCM's role in the executing and clearing process. For example, an FCM that both executes and clears an entire block order will possess more information than an FCM that executives or clears only a portion of an order. In order to fulfill its duties, and FCM at any level of the process should implement appropriate compliance measures. For example, an FCM may choose to spot check the allocations made to its customer accounts for conformity with the prefiled instructions it has received from the CTA and/or review the performance of accounts being traded pursuant to the same trading program.

Contemporaneous Filing of Instructions Via Electronic Transmission

Instructions for the allocation of contracts to accounts included in a block order can also be given at the time the CTA places the trade. NFA notes, however, that as a general rule allocation procedures for split and partial fills should be pre-filed with the appropriate FCM. For instructions on the number of contracts to be assigned to each account in the block order, many CTA's simply provide the necessary allocation information by phone when they call in the block order. For certain CTAs, however, providing allocation instructions verbally when the block order is placed may not be a practicable option. These CTAs may have hundreds of accounts included in the block order and providing detailed allocation information by phone may be extremely time consuming. Delaying the execution of the order while that process drags on might ultimately harm customers through market price slippage. For most of these CTAs, the prefiling of instructions provides an adequate alternative. However, for a limited number of CTAs, it may not be practicable to pre-file with the FCM a standing set of allocation instructions. The trading programs used by these CTAs are complex and dynamic. Given the fine tuning adjustments that are made on a daily basis, the exact number of contracts these CTAs allocate to any given account may vary from one day to the next, and may make the prefiling of instructions impracticable.

Under these circumstances, one way the CTA may provide the account identification information required under CFTC Regulation 1.35 would be to send the FCM, by facsimile or other form of electronic transmission, the breakdown of contracts to be assigned to each account included in the block order. The CTA would have to begin to send that information at the time the order is placed. Given the possibility of busy signals, paper jams and other limitations of electronic transmissions, there may be momentary delays in the completion of the transmission. Such delays should be neither commonplace nor lengthy, and the CTA should maintain appropriate documentation whenever such delays occur. When those delays do occur, however, CFTC Regulation 1.35 does not necessarily require the FCM to delay execution of the order until the electronic transmission of the allocation information is completed. To avoid delays in execution due to such transmission difficulties, the CTA must have provided the FCM with a written certification that:

(1) the CTA will begin the transmission to the FCM of the allocation breakdown contemporaneously with the placement of the order and will maintain appropriate documentation regarding any delays experienced in such transmission;

(2) prior to the placement of an order, the CTA has also generated a non-preferential allocation breakdown for each order which has been computer time-stamped indicating the date on which the order is to be placed and the date and time the allocation breakdown was printed;

(3) the CTA maintains with either their executing or clearing FCMs a complete list of all accounts traded by the CTA, by trading program if applicable;

(4) if a bunched order does not include all accounts within a particular trading program, then prior to the execution of the order these CTAs will identify for their FCMs the accounts which are included, by account identifier or designation;

(5) on a daily basis, these CTAs confirm that all their accounts have the correct allocation of contracts; and

(6) at least once a month, these CTAs analyze each trading program to ensure that the allocation method has been fair and equitable. If divergent performance results exist over time, then such results must be shown to be attributable to factors other than

the CTA's trade allocation or execution procedures. Additionally, a CTA must document its internal audit procedures and the results of its monthly analysis and maintain these audit procedures and results as firm records subject to review during an NFA audit.

An FCM which relies in good faith on the above certification would be deemed to be in compliance with CFTC Regulation 1.35. The CTA must also file a copy of that certification with NFA at least thirty days prior to implementing these procedures. This time period will provide NFA with an opportunity to review and verify the information contained in the certification.

For most block orders, the pre-filing of allocation instructions is the most practicable and preferred course of action. The procedure described herein relating to the contemporaneous filing of instructions via electronic transmission is an alternative available to those relatively few CTAs that can demonstrate a need for this alternative and meet the requirements of the certification. Each CTA availing itself of this alternative must not only adhere to the requirements of this Notice, but also demonstrate on a continuing basis to the appropriate regulator or self-regulator both its need to use this alternative and that the information in the certification is correct. If a CTA utilizes this alternative, it must adhere to this Notice's requirements or may face disciplinary action for its failure to do so. If any Member has questions concerning how this Interpretive Notice would apply to its operations, please contact NFA's Compliance Department.

IV. Commission Guidance

In any instance in which a CTA bunches multiple orders for different accounts into a single order for placement and execution, the antifraud provisions of Sections 4b and 4o of the Commodity Exchange Act may be violated if the resulting allocation is not fair, equitable and consistent in its treatment of the accounts included in the order. A CTA may bunch orders and provide, at the time of order placement with an executing registrant,[5] an allocation designator, as defined herein, that the Commission will find to constitute compliance with the account identification requirement of Regulation 1.35(a–1)(2)(i) for the accounts included in the order, by the CTA or the executing registrant, respectively, provided that, consistent with the NFA Notice and the following:

1. The CTA provides to each carrying FCM to which fills are to be allocated, either by prefiling allocation procedures or (consistent with the guidance set forth in the NFA Notice) contemporaneously providing allocation instructions with the placement of the order, a methodology to allocate contracts to customer accounts that identifies the ultimate customer account numbers and includes procedures for allocating prices and quantities for split and partial fills to those customers;

2. The order pertains to a group of specified accounts previously or contemporaneously identified to the carrying firm(s); and

3. The order is intended to provide fills for all accounts included in a single trading program.

4. The executing registrant documents the order as follows:

a. For purposes of the documentation required pursuant to this paragraph 4., an allocation designator means a symbol which represents all or any portion of the following information not reflected on the floor order as may be necessary to identify the ultimate customers, quantities and prices: that is, the trading program and the allocation procedures or methodology, including procedures for allocating prices and quantities for split and partial fills among carrying firms and/or among ultimate customers.

b. If the bunched order is to be allocated to customer accounts at one carrying FCM, prior to the time the order is executed, the floor order must reflect (1) the carrying FCM, (2) the order quantity, and (3) an allocation designator.

c. If the bunched order is to be given up for allocation to customer accounts at more than one carrying FCM, prior to the time the order is executed, the floor order must reflect (1) each carrying FCM, (2) the quantity to be given up to each such FCM, and (3) an allocation designator.[6] Consistent with the guidance provided in the NFA Notice, allocation instructions may be provided by electronic transmission to the executing registrant contemporaneously with order placement.

d. Alternatively, if the bunched order is to be given up for allocation to customer accounts at more than one FCM and the CTA has prefiled, consistent with exchange rules,[7]—with the NFA, a designated clearing member, an executing registrant, or an exchange—a set of allocation procedures which (1) Identifies each FCM to which trades will be given up, (2) identifies a methodology to determine how many contracts each FCM would receive, and (3) identifies an allocation designator, prior to the time the order is executed, the floor order must reflect the order quantity and the allocation designator identifying the prefiled procedures.

e. Prefiled procedures ordinarily would be standing procedures that would remain unchanged for a reasonable period of time.

5. Any time a CTA prefiles allocation procedures as provided herein and the CTA, rather than the executing or clearing registrant, provides specific allocations, after the execution of an order, implementing those prefiled procedures, the CTA must provide those allocations as soon as practicable.

Consistent with the NFA Notice, if an executing registrant has notice, based upon the information available to that registrant, that (1) allocation procedures are not prefiled, (2) the CTA's instructions do not conform to the prefiled procedures of (3) the give up and/or split and partial fill procedures or instructions result in allocations that are not being made in a fair, equitable and consistent manner, either by quantity or price, the executing registrant must make reasonable inquiry into the matter and, if appropriate, refer the matter to the proper regulatory authorities.

V. Conclusion

Based on the foregoing, FCMs, IBs, CTAs, their respective APs, and FBs who handle bunched orders for multiple accounts shall be deemed to be in compliance with the account identification requirement of Commission Regulation 1.35(a–1)(2)(i) if such orders are placed, recorded, executed, given up to multiple clearing firms, if applicable, and allocated to customer accounts in accordance with the provisions set forth in the NFA Notice and in compliance with the above-stated Commission guidance.

This Interpretation and Approval Order is based upon the Commission's understanding that (1) affected registrants, consistent with their responsibilities as set forth herein, will maintain documentation sufficient to demonstrate that the procedures thus authorized are in fact followed and (2) affected registrants, exchanges and the NFA will have effective systems in place to monitor compliance and to address apparent noncompliance with

[5] "Executing registrant" refers to the registrant with whom the CTA places the bunched order for execution, and may be either an FCM or a floor broker.

[6] If the allocation instructions are provided contemporaneously with order placement to a floor trading desk or floor broker's clerk, the person receiving the order may immediately transmit the order's terms (that is, contract, quantity and price) to the executing broker, either by hand signals, verbal or written communication, while continuing to record the allocation information on the floor order. Order execution need not be delayed while such information is being recorded.

[7] Any exchange which permits the prefiling of procedures with the NFA or an exchange pursuant to this interpretation of Regulation 1.35(a–1)(2)(i) must have procedures in place for their executing members to confirm that CTA allocation procedures, including designators, are in fact prefiled.

the terms hereof. The Commission intends to monitor the procedures and practices followed pursuant hereto, including through review of the results of audits of registrants handling bunched orders. Based thereon, the Commission may provide further guidance as appropriate.

Dated: May 5, 1997.

By the Commission.

Jean A. Webb,

Secretary of the Commission.

[FR Doc. 97–12161 Filed 5–8–97; 8:45 am]

BILLING CODE 6351–01–M

DEPARTMENT OF HEALTH AND HUMAN SERVICES

Food and Drug Administration

21 CFR Part 178

[Docket No. 95F–0163]

Indirect Food Additives: Adjuvants, Production Aids, and Sanitizers

AGENCY: Food and Drug Administration, HHS.

ACTION: Final rule.

SUMMARY: The Food and Drug Administration (FDA) is amending the food additive regulations to provide for the safe use of high-purity furnace black as a colorant for polymers intended for use in contact with food. This action is in response to a petition filed by Cabot Corp.

DATES: The regulation is effective May 9, 1997. Submit written objections and requests for a hearing by June 9, 1997. The Director of the Office of the Federal Register approves the incorporation by reference in accordance with 5 U.S.C. 552(a) and 1 CFR part 51 of a certain publication in 21 CFR 178.3297(e), effective May 9, 1997.

ADDRESSES: Submit written objections to the Dockets Management Branch (HFA–305), Food and Drug Administration, 12420 Parklawn Dr., rm. 1–23, Rockville, MD 20857.

FOR FURTHER INFORMATION CONTACT: Vir D. Anand, Center for Food Safety and Applied Nutrition (HFS–215), Food and Drug Administration, 200 C St. SW., Washington, DC 20204, 202–418–3081.

SUPPLEMENTARY INFORMATION: In a notice published in the **Federal Register** of July 20, 1995 (60 FR 37452), FDA announced that a food additive petition (FAP 5B4464) had been filed by Cabot Corp., 75 State St., Boston, MA 02109–1806. The petition proposed to amend the food additive regulations in § 178.3297 *Colorants for polymers* (21 CFR 178.3297) to provide for the safe use of high-purity furnace black as a colorant for polymers intended for use in contact with food.

In its evaluation of the safety of this additive, FDA has reviewed the safety of the additive itself and the chemical impurities that may be present in the additive resulting from its manufacturing process. Although the additive itself has not been shown to cause cancer, it has been found to contain minute amounts of polynuclear aromatic hydrocarbons (PAH's), which are carcinogenic impurities resulting from the manufacture of the additive. Residual amounts of reactants and manufacturing aids, such as polynuclear aromatic hydrocarbons in this instance, are commonly found as contaminants in chemical products, including food additives.

I. Determination of Safety

Under the general safety standard of the Federal Food, Drug, and Cosmetic Act (the act) (21 U.S.C. 348(c)(3)(A)), a food additive cannot be approved for a particular use unless a fair evaluation of the data available to FDA establishes that the additive is safe for that use. FDA's food additive regulations (21 CFR 170.3(i)) define safe as "a reasonable certainty in the minds of competent scientists that the substance is not harmful under the intended conditions of use."

The food additive anticancer, or Delaney, clause of the act (21 U.S.C. 348(c)(3)(A)) provides that no food additive shall be deemed safe if it is found to induce cancer when ingested by man or animal. Importantly, however, the Delaney clause applies to the additive itself and not to impurities in the additive. That is, where an additive itself has not been shown to cause cancer, but contains a carcinogenic impurity, the additive is properly evaluated under the general safety standard using risk assessment procedures to determine whether there is a reasonable certainty that no harm will result from the intended use of the additive (*Scott* v. *FDA*, 728 F.2d 322 (6th Cir. 1984)).

II. Safety of Petitioned Use of the Additive

FDA concludes that the additive, high-purity furnace black, is insoluble in common solvents, including aqueous and fatty foods. As a consequence, there is no potential for significant levels of migration of the furnace black to contacted food (Ref. 1).

FDA does not ordinarily consider chronic toxicological studies to be necessary to determine the safety of an additive whose use will result in such low exposure levels (Ref. 2), and the agency has not required such testing here. However, the agency has reviewed the available toxicological data on the additive and concludes that because there is no potential for significant levels of migration of furnace black to contacted food, there are no concerns regarding the safety of the additive itself.

FDA has evaluated the safety of this additive under the general safety standard, considering all available data and using risk assessment procedures to estimate the upper-bound limit of lifetime human risk presented by PAH's, the carcinogenic chemicals that may be present as impurities in the additive. The risk evaluation of PAH's has two aspects: (1) Assessment exposure to the impurities from the intended use of the additive; and (2) extrapolation of the risk observed in the animal bioassay to the conditions of exposure to humans.

A. Polynuclear Aromatic Hydrocarbons

FDA has estimated the worst-case exposure to PAH's from the petitioned use of the additive as a colorant in polymers to be no greater than 0.001 parts per billion (ppb) in the daily diet (3 kilograms (kg)), or 3 nanograms per person per day (ng/person/day). Further, the dietary concentration of benzo[a]pyrene, one member of the PAH family, was estimated to be no greater than 0.01 parts per trillion in the daily diet (3 kg), or 30 picograms /person/day (Ref. 1).

PAH's occur as a mixture of compounds; the toxicity of these compounds varies, and some members of the family have been shown to be carcinogenic in animal studies. In assessing the upper-bound limit of lifetime human risk, FDA prefers to use actual toxicity data for the specific contaminants. However, in the absence of such data, the agency believes that using the toxicity of one of the most potent cogeners in a family of contaminants will ensure that the upper-bound limit of lifetime human risk will not be underestimated. For this risk estimate, FDA has made the "worst-case" assumption that all PAH's in the additive have the same carcinogenic potency as benzo[a]pyrene, a member of the PAH family that current data show to be one of the most potent carcinogens of this group.

The agency used data from a carcinogenesis bioassay on benzo[a]pyrene, conducted by H. Brune et al. (Ref. 3), to estimate the upper-bound limit of lifetime human risk from exposure to this chemical resulting from the petitioned use of the additive. The

NATIONAL FUTURES ASSOCIATION
200 W. MADISON ST. • CHICAGO, IL • 60606-3447 • (312) 781-1300

June 12, 1997

Andrea M. Corcoran, Esq.
Director
Division of Trading & Markets
Commodity Futures Trading Commission
Three Lafayette Centre
1155 21st Street, N.W.
Washington, D.C. 20581

Dear Andrea:

The Commission recently published for public comment NFA's proposed Interpretive Notice regarding the allocation of block orders. That release describes alternative methods which CTA Members of NFA may use in transmitting allocation information relating to bunched orders. The relief is limited to CTA Members of NFA, in part, because NFA's monitoring of those firms provides further assurances that all allocations will be made in a way which ensures the fair treatment of all customers included in the block order.

Recently we have discussed the possibility of extending that relief to firms which are exempt from CTA registration. During those discussions I stated that NFA staff would be willing to recommend to our Board of Directors that NFA provide a comparable monitoring of such exempt CTAs, either through rule changes or by contract, which could provide a basis for the Commission to extend the relief referred to above to such exempt CTAs.

If you would like, we would be happy to discuss the details of such an arrangement prior to the July 17 meeting of our Executive Committee.

Sincerely,

Daniel J. Roth
General Counsel

DJR:ckm(ltr-dr\acblk)

E-Mail to NFA Staff
June 27, 1997

CFTC APPROVED INTERPRETIVE NOTICE TO NFA COMPLIANCE RULE 2-10 RELATING TO THE ALLOCATION OF BLOCK ORDERS FOR MULTIPLE ACCOUNTS

By letters dated December 7, 1995 and April 18, 1997, NFA submitted to the CFTC for its review and approval a proposed Interpretive Notice to NFA Compliance Rule 2-10 relating to the allocation of block orders for multiple accounts. Through a Federal Register release dated May 9, 1997, the Commission issued an Order approving NFA's Interpretive Notice as proposed. The Federal Register release also set forth the Commission's Interpretation regarding the account identification requirement of CFTC Regulation 1.35(a-1)(2)(i) as it pertains to the allocation of block orders. The CFTC Interpretation and the Order approving NFA's Interpretive Notice became effective on June 9, 1997. For a hardcopy of the Federal Register release, please contact Chris Makino (ext.1391). The text of NFA's approved Interpretive Notice is as follows:

NFA COMPLIANCE RULE 2-10

INTERPRETIVE NOTICE RELATING TO THE ALLOCATION OF BLOCK ORDERS FOR MULTIPLE ACCOUNTS

CFTC Regulation 1.35, which NFA Compliance Rule 2-10 adopts by reference, requires that each FCM receiving a customer order immediately prepare a written record of the order which includes an appropriate account identification. NFA Compliance Rule 2-4 requires CTA Members to provide FCMs with that required information. The purpose of the regulation is to prevent various forms of customer abuse, such as fraudulent allocation of trades, by providing an adequate audit trail which allows customer orders to be tracked at every step of the order processing system. Since this regulation was originally adopted, however, there have been dramatic changes in the way business is done. With the explosive growth of the managed funds business and the increasing use of "give-up" agreements, it is not at all uncommon for some CTAs to place block orders for hundreds of accounts on markets around the world, with orders executed by one or more FCMs and cleared by other FCMs. How the basic requirements of CFTC Regulation 1.35 apply to block orders for multiple accounts ("block or bunched order") has been the source of considerable difficulty and confusion. While this Notice does not attempt to address all of the issues which can arise in this context, it does provide guidance on commonly recurring questions.

With respect to block orders, CFTC Regulation 1.35 has been interpreted to require that, at or before the time the order is placed, the FCM must be provided with information which identifies the accounts included in the block order and which specifies the number of contracts to be allotted to each account. In most instances, a CTA can verbally provide all of that information contemporaneously with the placement of the order. Some of the time, however, this is not practical. Verbal transmission of numerous account numbers and allocation information could result in price slippage in filling block market orders. Most CTAs can deal with this problem by pre-filing with the FCM standing instructions which contain all of the necessary information.

For a limited number of larger and more sophisticated CTAs, however, pre-filing standing instructions may not be practicable either. For these CTAs, although their basic allocation methodology does not change, the specific allocation instructions produced by the methodology may change on a daily basis. For example, a large CTA with a dynamic trading program may regularly change its order size based upon market volatility and historical price data. Certainly, if a CTA changes its order size, then the precise number of contracts allocated to each account within the CTA's trading program will also change. Other factors could cause regular changes to a CTA's order size and/or allocation breakdowns such as the number of accounts which open and close and any additions and withdrawals made in existing accounts. In the above instances, although the specific application of a CTA's allocation methodology to the universe of its accounts may cause allocation adjustments, the allocation methodology itself remains constant. Because the methodology must meet the standards of this Notice, it must be designed to provide non-preferential treatment for all accounts. Though these CTAs could provide the allocation information to their FCMs in advance of each order, this information could disclose their trading strategies, which they are obviously reluctant to do.

In general, then, there are two alternatives to the verbal filing of all account identification data contemporaneously with order placement:

1) pre-filing of instructions for identification of accounts included in block orders and the allocation of executed block orders to accounts; and

2) under the stringent requirements described below, the contemporaneous filing of allocation instructions via electronic transmission.

This Interpretive Notice clarifies how either approach can be implemented consistent with the requirements of CFTC Regulation 1.35.

PRE-FILING OF ALLOCATION INSTRUCTIONS

Allocation instructions for trades made through block orders for multiple accounts must deal with two separate issues. The first, which arises in all such orders, involves the question of how the total number of contracts should be allocated to the various accounts included in the block order. The second involves the allocation of split or partial fills. For example, a CTA may place a block order of 100 contracts for multiple accounts. In many instances, however, a market order for 100 contracts may be filled at a number of different prices. Similarly, if an order is to be filled at a particular price, the

FCM may be able to execute some but not all of the 100 lot order. In either example, the question arises of how the different prices or the contracts in the partial fill should be allocated among the accounts included in the block order.

The same set of core principles govern the procedures to be used in handling both of these issues. Any procedure for the general allocation of trades or the allocation of split and partial fills must be:

- designed to meet the overriding regulatory objective that allocations are non-preferential, such that no account or group of accounts receive consistently favorable or unfavorable treatment;
- sufficiently objective and specific that the appropriate allocation for any given trade can be verified in any audit by NFA, an exchange DSRO, the CFTC or the FCM's and CTA's own accountants; and
- consistently applied by the Member firm.

In performing audits, we have noted that Members employ a wide variety of methods to allocate split and partial fills, some of which satisfy the standards stated above and some of which do not. The following examples of procedures for the allocation of split and partial fills generally satisfy the standards stated above.

Example #1 - Rotation of Accounts

One basic allocation procedure involves a rotation of accounts on a regular cycle, usually daily or weekly, which receive the most favorable fills. For example, if a firm has 100 accounts trading a particular trading program, in the first phase of the cycle, Account #1 receives the best fill, Account #2 the second best, etc. In phase 2 of the cycle, Account #2 receives the best fill and Account #1 moves to the end of the line and receives the least favorable fill.

Example #2 - Random Allocation

Some firms prepare on a daily basis a computer generated random order of accounts and allocate the best price to the first account on the list and the worst to the last. This method would satisfy the standards stated above.

Example #3 - Highest Prices to the Highest Account Numbers

Some firms rank accounts in order of their account numbers and then allocate the highest fill prices to the accounts with the highest account numbers. Any advantage the higher numbered accounts enjoy on the sell order are theoretically offset by the disadvantage on the buy orders. Although under certain market conditions this may not always be true, the method generally complies with the standards.

Example #4 - Average Price and Quantity

With regard to split and partial fills, allocations made pursuant to exchange rules which provide for the allocation of average prices and quantities in block orders for multiple accounts would, of course, be acceptable. In addition, certain firms may have internal programs which calculate the average price for each block order and allocate the actual fill prices among the accounts included in the order to approximate, as closely as possible, the average fill price. These internal programs must specifically satisfy the standards stated above and be documented by the Member firm.

Though the examples cited above are the ones NFA most commonly sees in audits, others may offer comparable treatment. We would also note that 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. In addition, certain variations of these basic methods would not satisfy those requirements. For example, it would not be acceptable for the CTA to deviate from the regular rotation to accommodate an account whose performance is lagging behind others in the same program. This would inject the CTA's subjective judgment into the process, would render the allocation impossible to duplicate in the audit process and would open the potential for customer abuse.

One related issue which has generated some confusion is whether the responsibility for the allocation of split and partial fills rests with the CTA or with the FCM. The CTA certainly has the sole responsibility for ensuring that the procedures are appropriate in light of its approach to trading. With respect to the actual implementation of the procedures, since the CTA is directing the trading in the accounts, the responsibility for allocating split and partial fills among the accounts should rest with the CTA. However, there is nothing under NFA rules to preclude an FCM from agreeing to undertake this responsibility, whether it clears or executes the trades, pursuant to either its own procedures or to those supplied by the CTA. Any division of responsibilities agreed to by the FCM and CTA should be clearly documented.

There is also a good deal of confusion on how the basic principles of CFTC Regulation 1.35 apply to block orders executed on a "give-up" basis, a process which was essentially unknown when Regulation 1.35 was originally adopted. Subject to exchange rules, in any given block order there may be multiple executing FCMs, multiple clearing FCMs or multiple FCMs serving each of these functions. The exact form of customer identification which the FCM must receive from the CTA under Regulation 1.35 may vary depending on the FCM's role in filling the order. Essentially, each FCM must receive sufficient information to allow it to perform its function. For executing FCMs, this includes, at a minimum, the number of contracts to be given up to each clearing FCM and instructions for allocation of split and partial fills among those FCMs. Information concerning the number of contracts to be allocated to each account included in the block order must be provided to the FCM which will carry out those instructions, which, in most cases, will be the FCM clearing the accounts. All of this information must be provided at or before the time the order is placed and could be provided by pre-filing a set of instructions. If the pre-filed instructions for the general allocation or the allocation of split and partial fills meet the standards set forth in this Notice, then the clerical task of implementing the instructions could be performed by either the FCM or the CTA.

If that clerical function is performed by the CTA, this does not suggest that the FCM is relieved of any further responsibility. The 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 (e.g., the CFTC or the NFA or its DSRO). Obviously, whether an FCM has such notice depends upon the information that the FCM has or should have, which, in turn, is based upon the FCM's role in the executing and clearing process. For example, an FCM that both executes and clears an entire block order will possess more information than an FCM that executes or clears only a portion of an order. In order to fulfill its duties, an FCM at any level of the process should implement appropriate compliance measures. For example, an FCM may choose to spot check the allocations made to its customer accounts for conformity with the prefiled instructions it has received from the CTA and/or review the performance of accounts being traded pursuant to the same trading program.

CONTEMPORANEOUS FILING OF INSTRUCTIONS VIA ELECTRONIC TRANSMISSION

Instructions for the allocation of contracts to accounts included in a block order can also be given at the time the CTA places the trade. NFA notes, however, that as a general rule allocation procedures for split and partial fills should be pre-filed with the appropriate FCM. For instructions on the number of contracts to be assigned to each account in the block order, many CTAs simply provide the necessary allocation information by phone when they call in the block order. For certain CTAs, however, providing allocation instructions verbally when the block order is placed may not be a practicable option. These CTAs may have hundreds of accounts included in the block order and providing detailed allocation information by phone may be extremely time consuming. Delaying the execution of the order while that process drags on might ultimately harm customers through market price slippage. For most of these CTAs, the prefiling of instructions provides an adequate alternative. However, for a limited number of CTAs, it may not be practicable to pre-file with the FCM a standing set of allocation instructions. The trading programs used by these CTAs are complex and dynamic. Given the fine tuning adjustments that are made on a daily basis, the exact number of contracts these CTAs allocate to any given account may vary from one day to the next, and may make the prefiling of instructions impracticable.

Under these circumstances, one way the CTA may provide the account identification information required under CFTC Regulation 1.35 would be to send the FCM, by facsimile or other form of electronic transmission, the breakdown of contracts to be assigned to each account included in the block order. The CTA would have to begin to send that information at the time the order is placed. Given the possibility of busy signals, paper jams and other limitations of electronic transmissions, there may be momentary delays in the completion of the transmission. Such delays should be neither commonplace nor lengthy, and the CTA should maintain appropriate documentation whenever such delays occur. When those delays do occur, however, CFTC Regulation 1.35 does not necessarily require the FCM to delay execution of the order until the electronic transmission of the allocation information is completed. To avoid delays in execution due to such transmission difficulties, the CTA must have provided the FCM with a written certification that:

(1) the CTA will begin the transmission to the FCM of the allocation breakdown contemporaneously with the placement of the order and will maintain appropriate documentation regarding any delays experienced in such transmission;

(2) prior to the placement of an order, the CTA has also generated a non-preferential allocation breakdown for each order which has been computer time-stamped indicating the date on which the order is to be placed and the date and time the allocation breakdown was printed;

(3) the CTA maintains with either their executing or clearing FCMs a complete list of all accounts traded by the CTA, by trading program if applicable;

(4) if a bunched order does not include all accounts within a particular trading program, then prior to the execution of the order these CTAs will identify for their FCMs the accounts which are included, by account identifier or designation;

(5) on a daily basis, these CTAs confirm that all their accounts have the correct allocation of contracts; and

(6) at least once a month, these CTAs analyze each trading program to ensure that the allocation method has been fair and equitable. If divergent performance results exist over time, then such results must be shown to be attributable to factors other than the CTA's trade allocation or execution procedures. Additionally, a CTA must document its internal audit procedures and the results of its monthly analysis and maintain these audit procedures and results as firm records subject to review during an NFA audit.

An FCM which relies in good faith on the above certification would be deemed to be in compliance with CFTC Regulation 1.35. The CTA must also file a copy of that certification with NFA at least thirty days prior to implementing these procedures. This time period will provide NFA with an opportunity to review and verify the information contained in the certification.

For most block orders, the pre-filing of allocation instructions is the most practicable and preferred course of action. The procedure described herein relating to the contemporaneous filing of instructions via electronic transmission is an alternative available to those relatively few CTAs that can demonstrate a need for this alternative and meet the requirements of the certification. Each CTA availing itself of this alternative must not only adhere to the requirements of this Notice, but also demonstrate on a continuing basis to the appropriate regulator or self-regulator both its need to use this alternative and that the information in the certification is correct. If a CTA utilizes this alternative, it must adhere to this Notice's requirements or may face disciplinary action for its failure to do so. If any Member has questions concerning how this Interpretive Notice would apply to its operations, please contact NFA's Compliance Department.