

## MEMORANDUM

**TO:** Clients and Friends of Dorsey & Whitney LLP

**DATE:** June 23, 2003

**RE:** Account Identification for Eligible Bunched Orders

On June 11, 2003, the Commodity Futures Trading Commission (the "CFTC") issued final amendments to CFTC Regulation §1.35(a-1)(5) (the "Rule"). The Rule is designed to expand the eligibility to all customers to have their orders bunched, thus enabling customers to receive better execution and pricing of their orders. Recognizing the increasingly electronic and flexible nature of modern futures markets, the CFTC designed the amendments to the Rule to simplify the process of bunching orders and to clarify respective responsibilities of account managers ("Managers") and futures commission merchants ("FCMs").

### 1. ELIGIBLE CUSTOMERS

Prior to the amendments, the Rule limited the eligibility for inclusion in a bunched order essentially to "sophisticated customers." Under the amended Rule, the CFTC expanded eligibility to all customers who provide written investment discretion to Managers.

In addition, the CFTC has decided to retain the interpretive notice found in Appendix C to Part 1 of the CFTC Regulations promulgated under the Commodity Exchange Act, as amended (the "CE Act"). Appendix C allows commodity trading advisors ("CTAs") to bunch orders if they pre-file their allocation procedures with a clearing member, the National Futures Association (the "NFA") or an exchange, as guidance to Managers who may wish to allocate orders under the circumstances described in Appendix C and also as an example of permissible allocation methods. However, the CFTC may reconsider this issue in the future due to the inconsistency between the old and amended Rule. Furthermore, if any conflict between the Rule and Appendix C arises, the standards set forth in the Rule will supercede any interpretive guidance on bunched orders issued by the CFTC.

### 2. ELIGIBLE MANAGERS

The amended Rule has expanded the definition of Managers. Previously, the Rule limited eligible Managers to registered CTAs, registered investment advisers ("IAs"), banks, insurance companies, trust companies and savings and loan associations.

Under the new Rule, the category of eligible Managers has been expanded to include additional entities. Specifically, Managers now include CTAs and IAs who are exempt from registration or who are excluded from the definition of CTA or IA by operation of law or rule. Moreover, the amended Rule allows foreign advisors who exercise discretionary trading authority over the accounts of non-United States persons, to be eligible regardless of whether they have been granted an exemption pursuant to CFTC §30.10.\*

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\* CFTC Regulation §30.10 permits firms to solicit and accept orders for foreign futures and option contracts from United States customers without registering under the CE Act, provided that such foreign firm is in compliance with the rules and regulations of the jurisdiction in which the firm is located.

### 3. INFORMATION

The Rule has converted the disclosure requirement to an information availability requirement. Rather than mandating disclosure of information, the amended Rule requires a Manager to make the following types of information available upon request:

- (1) the general nature of the allocation methodology the Manager uses;
- (2) whether accounts in which the Manager may have an interest may be included with customer accounts in bunched orders eligible for post-execution allocation; and
- (3) summary or composite data sufficient for that customer to compare its results with those of other relevant customers and any account in which the Manager has an interest, if applicable.

Finally, under the amended Rule, the Manager must only make available the results of executions and allocations as opposed to broader account performance results.

### 4. ALLOCATION

The amended Rule clarifies the allocation procedures for post-execution allocation of bunched orders and the respective duties of Managers and FCMs. The CFTC will examine allocation fairness over time, rather than trade-by-trade. Specifically, because the requirement that each Manager provide certain certifications to the carrying FCM before bunching has proven burdensome to both Managers and FCMs, the amended Rule has removed such requirement.

Managers must observe three requirements when allocating post-execution. First, allocations must be fair and equitable, and no account or groups of accounts may receive consistently favorable or unfavorable treatment.

Second, all Managers must use an allocation methodology sufficiently objective and specific to permit independent verification of the fairness of the allocation. The Manager may exercise discretion over the allocation methodology, because such strategies may vary in order to treat all customers fairly. However, the CFTC must be able to reconstruct the allocation methodology sufficiently to verify that the Manager is acting without bias.

Third, Managers must provide information to FCMs sufficiently before the end of the day on which the order is executed to ensure that clearing records identify the ultimate customer for each trade.

Under the amended Rule, Managers, not FCMs, are responsible for the allocation of bunched orders. However, FCMs will continue to be responsible for monitoring unusual account activities. It would be a violation of an FCM's duty if such FCM failed to take appropriate action after noticing fraudulent allocations. "Appropriate action" for an FCM would be to make a reasonable inquiry into such matter and, if necessary, refer the matter to the proper regulatory authority.

## 5. RECORDS

The amended Rule requires Managers to maintain the following two types of records:

- (1) records of information as listed under “3. Information,” above; and
- (2) records that allow independent verification of the fairness of the Manager’s allocation methodology as discussed under the “4. Allocation,” above.

Such records must be made available to any representative of the CFTC, the United States Department of Justice, or other appropriate regulatory body.

The amended Rule contains provisions to address cases in which Managers fail to provide the CFTC with the information requested pursuant to the amended Rule. Specifically, the CFTC may prohibit the Manager from submitting orders for execution on designated contract markets and prohibit FCMs from accepting orders from such Managers. The failure of Managers to comply with a request for information would be sufficient to trigger this prohibition. Because preventing the Manager from trading on contract markets would have a serious impact on the Manager, and possibly its customers, such penalty may only be invoked by the CFTC when it has a reason to believe that the Manager has failed to comply with an information request. Additionally, the Manager will have the opportunity for a hearing to contest the prohibition.

The amended Rule also provides that FCMs must retain certain records. FCMs that execute trades for orders eligible for bunching, or that carry accounts to which contracts executed for such orders are allocated, must retain records that identify each order subject to post-execution allocation and the accounts to which contracts executed for such order are allocated.

So that FCMs are able to keep such records, the Manager employing post-execution allocation provisions generally is expected to forward written allocation instructions (*e.g.*, via facsimile, e-mail or other electronic means) to the clearing firm. If the Manager provides allocation instructions orally, the FCM must create a written record of the Manager’s instructions. Each of these records must be available to the CFTC and other regulatory agencies or self-regulatory organizations.

## 6. ACCOUNT CERTIFICATION AND SELF REGULATORY ORGANIZATION RULE ENFORCEMENT AND AUDIT PROCEDURES

Because the Rule no longer requires a Manager to send certifications of its compliance with the Rule to FCMs, and due to the fact that the CFTC has converted the recordkeeping requirements of the Rule into requirements for making information available, the amended Rule no longer requires self regulatory organizations to adopt procedures to determine compliance with the old Rule’s recordkeeping requirements.

If you have any questions, please do not hesitate to contact Michael F. Griffin at (212) 415-9222 or [griffin.michael@dorseyllp.com](mailto:griffin.michael@dorseyllp.com); J.P. Bruynes at (212) 415-9238 or [bruynes.john@dorseyllp.com](mailto:bruynes.john@dorseyllp.com); or Robert E. Holton at (212) 415-9226 or [holton.robert@dorseyllp.com](mailto:holton.robert@dorseyllp.com).

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