§ 758.3(f)(1)
§ 758.3(g)(1)
§ 758.3(g)(2)(i)
§ 758.3(g)(2)(ii)—2 references
§ 758.3(g)(3)
§ 758.3(h)(1)

Dated: August 18, 1998

R. Roger Majak,

Assistant Secretary for Export Administration.

[FR Doc. 98–23018 Filed 8–26–98; 8:45 am]

BILLING CODE 3510–33–P

COMMODITY FUTURES TRADING COMMISSION

17 CFR Part 1

Orders Eligible for Post-execution Allocation

AGENCY: Commodity Futures Trading Commission.

ACTION: Final rule.

SUMMARY: The Commodity Futures Trading Commission (''Commission'') has amended Commission Regulation 1.35(a–1) to allow bunched orders for eligible customers to be placed on a contract market without specific customer account identification either at the time of order placement or at the time of report of execution. Specifically, the amendment exempts from the customer account identification requirements of Regulation 1.35(a–1)(1), (2)(i), and (4) bunched futures and/or option orders placed by eligible account managers on behalf of eligible customer accounts. The amendment permits bunched orders entered on behalf of these accounts to be allocated no later than the end of the day on which the order is executed.

EFFECTIVE DATE: October 26, 1998.

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I. Background

A. Current Regulatory Requirements

The Commission's Regulations 1.35(a–1) recordkeeping requirements, in effect since March 24, 1972, specify that customer orders must be recorded promptly and include customer account identification at the time of order entry and the time of report of execution. Specifically, Commission Regulation 1.35(a–1)(1) requires that each futures commission merchant (''FCM'') and each introducing broker (''IB'') receiving a customer's order immediately prepare a written record of that order, which includes an account identifier for that customer. 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 writing immediately prepare a written record of that order, including the appropriate customer account identification. Regulation 1.35(a–1)(4) requires, among other things, that each member of a contract market reporting the execution of a customer's order from the floor of a contract market include the account identification on a written record of that order.

B. Prior Regulatory Action

On June 8, 1992, the Commission published for public comment a proposed amendment to Chicago Mercantile Exchange (''CME'') Rule 536 (''1992 proposal'').[1] The amendment would have exempted from CME customer account designation requirements certain orders placed by a limited group of investment managers on behalf of specified institutional accounts. The orders would have been required to be allocated prior to the end of the day. The Commission received 31 comments, which were addressed in the Commission's subsequent proposed amendment to Regulation 1.35, discussed below.[2]

On May 3, 1993, the Commission published for public comment proposed amendments to Regulation 1.35(a–1) designed to accommodate the CME proposal (''1993 proposal'')[3] and the related comments thereon. In addition to amending Regulations 1.35(a–1)(1), (2), and (4), the Commission proposed to add paragraphs 1.35(a–1) (5) and (6). Paragraph (5), which addressed the placement of bunched orders and the use of predetermined allocation formulas, was superseded by the Commission's Notice of Interpretation and Approval Order, published May 9, 1997.[4] This Order approved the National Futures Association (''NFA'') Interpretative Notice to NFA Compliance Rule 2–10 Relating to the Allocation of Block Orders for Multiple Accounts which established standards and procedures for allocating orders pursuant to predetermined allocation schemes.[5]

Paragraph (6) was the Commission's followup to CME's 1992 proposal. Paragraph (6) proposed allowing the placement of certain bunched ''intermarket'' orders without customer account identification and permitting the allocation of those orders at the end of the day. The Commission stated that the proposed regulation would encourage and facilitate institutional participation in the futures markets subject to customer protection requirements that were consistent with the sophistication of the institutional

[1] 57 FR 24251 (June 8, 1992).

[2] Twenty-six of the comments evidenced support for the proposed rule amendment, four were opposed to the amendment, and one recommended caution.

[3] ''Account Identification for Orders Submitted on Behalf of Multiple Customer Accounts,'' 58 FR 26274 (May 3, 1993).

[4] 62 FR 25470 (May 9, 1997).

[5] The Order also provided additional Commission guidance regarding bunched orders and allocation procedures. The guidance provided therein has since been published as Appendix C to Part One of the Commission's regulations.

customers. The Commission received 34 comments. Most commenters found the proposed rule burdensome and too restrictive to be of value. In particular, many commenters objected (1) to the proposed requirement for an intermarket trading strategy involving securities and (2) to the detail of recordkeeping and certification requirements.

Following review of the comments on the 1993 proposal, the Commission staff continued to consider alternative means to provide relief from the account identification requirements without increasing the potential for preferential allocation.

C. Proposed Amendment to Regulation 1.35(a–1)

On January 7, 1998, the Commission published the reproposed amendments to Regulation 1.35(a–1) for public comment (''1998 proposal'') as a response to the concerns raised in the 1993 proposal.[6] In addition to amending Regulation 1.35(a–1)(1), (2), and (4), the Commission proposed to add paragraph 1.35(a–1)(5). Under the 1998 proposal, a specific customer's account identifier need not be recorded at the time an eligible bunched order (''eligible order'') is placed or upon report of execution, and the order could be allocated by the end of the day on which it was executed, provided that certain requirements were met. The order must be handled in accordance with contract market rules submitted to the Commission pursuant to Section 5a(a)(12)(A) of the Act and Regulation 1.41.

The Commission received 13 comments in response to the 1998 proposal. Commenters included four associations,[7] six exchanges,[8] and four firms registered with the Commission as FCMs.[9] Although most comments found that the 1998 proposal eliminated many of the practical difficulties of the 1993 proposal, they also contended that unnecessary restrictions remained. Among the 1998 proposal's provisions found to be overly restrictive were the portfolio requirement,[10] the customer consent requirement, the limitation on proprietary interest, the exclusion of foreign advisers as eligible account managers, and the exclusion of natural persons as eligible customers.

The Commission has carefully reviewed the comments received and agrees with the commenters that these restrictions can be eliminated and that certain other provisions can be modified. With regard to the proposed customer consent requirement and the limitation on proprietary interest, the Commission has adopted the suggestion of many commenters that, as detailed below, disclosure to the customer concerning allocation standards and procedures is an appropriate and less burdensome substitute that provides the same kind of customer protection. Based on its review of the comments, the Commission has modified and clarified the final rule as appropriate.

II. Amendments to Commission Regulation 1.35(a–1)

The Commission is amending Regulation 1.35(a–1). Under Regulation 1.35(a–1)(5), Orders eligible for post-execution allocation, specific customer account identifiers for accounts included in bunched orders need not be recorded at time of order placement or upon report of execution if certain requirements are met. The bunched order must be placed by an eligible account manager [11] on behalf of eligible customer accounts and must be handled in accordance with contract market rules that have been submitted to the Commission pursuant to Section 5a(a)(12)(A) of the Act and Regulation 1.41. In the discussion below, the Commission sets forth each of the components of its 1998 proposal, as summary of any pertinent comments received, and the manner in which the final rule addresses the issue.

A. Eligible Orders

1. Proposed Regulation 1.35(a–1)(5)(i).

The 1998 proposal required that bunched orders placed, executed, and allocated pursuant to the proposed regulation must be placed by an eligible account manager on behalf of consenting eligible customers as part of its management of a portfolio also containing instruments either exempt from regulation pursuant to the Commission's regulations or excluded from Commission regulation under the Act.

The consent requirement was based upon the belief that the eligible account owners should have the opportunity to consent affirmatively to participate in the post-execution allocation procedure. Further, the account manager should be the appropriate party to obtain that consent and to advise the FCM allocating the order so that the FCM could assure that allocations ere made only to the eligible accounts.

The portfolio requirement was based on the originally stated rationale for proposing that post-execution allocation be permitted, *i.e.,* to permit account managers to provide equivalent treatment to customers' accounts traded pursuant to strategies involving activity in both futures markets and non-futures markets. Where trades were executed only on domestic futures exchanges, the Commission stated that the account manager should be able to achieve equivalent treatment of customers' accounts while complying with either the existing customer account identifier requirements [12] or exchange average pricing rules. Nonetheless, the Commission requested comments concerning the placement of futures-only orders where the use of predetermined allocation formulas or average pricing would be insufficient to provide equivalent treatment to customers' accounts.

2. Comments Received

All commenters who addressed the issue of consent suggested that disclosure to the customer that orders would be allocated on a post-execution basis, rather than written consent, would be appropriate.[13] NFA and MFA

[6] ''Account Identification for Eligible Bunched Orders,'' 63 FR 695 (January 7, 1998).

[7] NFA, Managed Funds Association (''MFA''), Investment Company Institute (''ICI''), and the Association of the Bar of the City of New York (''NY Bar''). The NFA comment was derived after discussions among members of a subcommittee of NFA's Special Committee for the Review of a Multi-Tiered Regulatory Approach.

[8] Chicago Mercantile Exchange, Chicago Board of Trade (''CBT''), New York Mercantile Exchange (including Commodity Exchange, Inc.) (''NYMEX''), Coffee, Sugar & Cocoa Exchange, Inc. (''CSCE''), and New York Cotton Exchange (''NYCE'').

[9] Goldman, Sachs & Co. (''Goldman''), E D & F Man International (''Man'') FIMAT Futures USA, and Lehman Brothers, Inc. The latter two firms are not individually further referenced because their comment letters were written to support the NFA comment.

[10] The proposal required that eligible orders must be placed as part of the account manager's management of a portfolio also containing instruments which are either exempt from regulation pursuant to the Commission's regulations or excluded from Commission regulation under the Act. This was intended to permit account managers handling portfolios involving futures and other instruments to allocate as to all components of the portfolio at the end of the day.

[11] The term ''account manager'' hereinafter is used to include investment advisers, commodity trading advisors (''CTA''), and other persons identified in paragraph 1.35(a–1)(5)(i) of the final regulation who would place orders eligible for post-execution allocation in accordance with the procedures set forth in the amendment.

[12] Regulation 1.35(a–1)(1) and (2)(i) or the predetermined allocation formula exceptions thereto as described in Appendix C to Part One of the Commission's regulations.

[13] NFA, ICI, and CBT. CME and NYMEX commented that the Commission should defer regulation of the relationship between the account manager and the account manager's customer to the account manager's primary regulator, but that, if the Commission does act in this area, it should require only disclosure. MFA commented that all customers, not just the most sophisticated, should

recommended that required disclosure should include specific customer protection information including, among other things, a description of any allocation methodology.[14]

All commenters addressing the portfolio requirement suggested that it be eliminated and that futures-only orders be permitted to be allocated on a post-execution basis.[15] Commenters represented that there are situations in which futures-only orders need to be allocated on a post-execution basis in order to attain fairness across accounts, thus satisfying the original rationale for the proposal. Included among the instances described by commenters where relief may be necessary were trading advisors who trade esoteric volatility spreads, who arbitrage, or who otherwise trade combinations of different futures and option contracts.[16] MFA and NYCE commented that relief may be necessary with regard to orders for which the account manager seeks to average price where the trading strategies are such that trading decisions made intraday are dependent upon prior trades or allocations. MFA and NYMEX stated that relief would be necessary in the case of orders for multiple accounts at multiple FCMs that are placed on more than one futures exchange. MFA identified a need for relief for orders for which a partial fill received at one exchange must be rounded out by an order in a related instrument at another exchange. Finally, NFA and MFA stated that relief was necessary when large orders are placed through a series of smaller orders in order to disguise the size of the order or to alleviate the impact of one order upon market prices.[17] Commenters also noted that average pricing is not a viable alternative in that it is not available at all exchanges and is not structured to handle partial fills.[18] Similarly, NFA and NY Bar noted that the use of predetermined allocation instructions may not be practicable given the complex and dynamic trading programs used by large, sophisticated advisors.

3. Final Regulation 1.35(a–1)(5)

After consideration of the comments, the Commission has concluded that it would be appropriate to delete the requirement for eligible account owners to consent to orders being allocated on a post-execution basis. First, the customers for whom orders could be placed and allocated pursuant to these procedures have previously been identified by the Commission as sufficiently sophisticated to monitor the results of post-execution allocations in their accounts.[19] Second, based in large part upon comments submitted by NFA and MFA, the Commission has included in the final regulation a requirement that the account manager disclose detailed information to its eligible customers. This information, discussed in detail in final rule paragraph 1.35(a–1)(5)(iii) below, is designed to apprise the account owner of allocation methodologies, fairness standards, availability of data for comparing returns on investment, and any proprietary accounts that may be included in the bunched order. These disclosures serve as an appropriate substitute for formal customer consent.

The Commission has also determined that it would be appropriate to delete the portfolio requirement. As previously stated, the overriding rationale for allowing post-execution allocation is to permit equivalent treatment of customers' accounts. The Commission believes that the commenters have sufficiently demonstrated that there are situations in which account managers placing futures-only bunched orders for eligible customers may need the relief afforded by post-execution allocation in order to achieve equivalent treatment of costumers' accounts. Further, the commenters have sufficiently demonstrated that there are also situations in which the use of either predetermined allocation instructions or average pricing may not be adequate to assure equitable treatment of customer accounts included in a bunched order.

B. Eligible Account Managers

1. Proposed Regulation 1.35(a–1)(5)(ii)

The 1998 proposal required that the account manager placing and/or directing the allocation of an eligible order must be one of the following which has been granted investment discretion with regard to eligible customer accounts: a CTA registered with the Commission pursuant to the Act; an investment adviser registered with the Securities and Exchange Commission ("SEC"), pursuant to the Investment Advisers Act of 1940; or a bank, insurance company, trust company, or savings and loan association subject to federal or state regulation.[20]

The Commission stated that these entities might be able to use the relief afforded by the eligible order procedures to achieve equivalent results for eligible customer accounts being traded pursuant to strategies involving trading activity in more that one market. Eligible account managers would be able to allocate futures and option trades in the same manner as they allocated trades on securities exchanges and over-the-counter markets.[21] Additionally, these entities' fiduciary activities were subject to oversight by various state or federal regulatory agencies.

2. Comments Received

Numerous commenters stated that foreign advisers play a significant role in U.S. financial markets[22] and suggested that the list of eligible account managers should be expanded to include foreign advisers.[23] MFA suggested including investment advisers exempt from SEC registration under Section 203(b)(3) of the Investment Advisers Act of 1940. Finally, CBT proposed that exchanges should be

be able to participate in bunched orders being allocated on a post-execution basis. Under these circumstances, disclosure would be adequate for the sophisticated customers but signed acknowledgements evidencing customer consent should be required from unsophisticated customers.

[14] These recommendations are discussed in detail below in paragraph 1.35(a–1)(5)(iii) of the final rule.

[15] NFA, MFA, CBT, NYMEX, CSCE, NYCE, and Goldman. NY Bar commented that futures-only orders placed on more than one futures exchange should be eligible for post-execution allocation.

[16] NFA, CBT, NYMEX, and CSCE.

[17] Additionally, Goldman commented that account managers executing futures-only orders have the same need to respond rapidly to market movements and to use trading models and systems that are complex and may involve numerous adjustments throughout the course of a single trading day. As a result, it may often be necessary for an account manager, particularly in fast moving markets, to be able to execute orders instantly and to allocate the fills after completion of the transaction.

[18] NFA, NY Bar, NYMEX, CSCE, NYCE, and Goldman.

[19] 63 FR 695, 700. The eligible customers are identified and discussed below in paragraph 1.35(a–1)(5)(ii) of the final rule.

[20] On the basis of comments to the 1993 proposal, the 1998 proposal included CTAs as eligible account managers. Otherwise, the group of entities proposed to be eligible account managers was identical to that originally found in the 1993 proposal.

[21] *See, e.g.,* Interpretation 88–3 of New York Stock Exchange ("NYSE") Rule 410(a)(3): "Member organizations may accept block orders and permit investment advisors to make allocations on such orders to customers and remain in compliance with Rule 410(a)(3) provided that the organizations receive specific account designations or customer names by the end of the business day."

[22] NFA, CBT, CSCE, NYCE, and Goldman.

[23] NFA, MFA, NYCE, Man and CSCE (foreign advisors registered with, or exempt from, Commission registration, regulated in the advisor's home jurisdiction, and providing advice to non-U.S. persons), CBT (registered with the Commission), and Goldman (operating pursuant to Regulation 30.10 exemptions, located in countries that have received Regulation 30.10 exemptions, or otherwise).

afforded the flexibility to expand the relief, on a case-by-case basis, to other account mangers who are adequately regulated and subject to fiduciary liability.

3. Final Regulation 1.35(a–1)(5)(i)

After consideration of the comments, the Commission believes that it is appropriate to expand the list of eligible account managers to include foreign advisers who provide advice solely to foreign persons.[24] However, the Commission remains concerned that foreign advisers are not subject to U.S. regulation and could use the ability to allocate orders among customers after execution as a vehicle to engage in fraud, money laundering or other abusive financial schemes. Thus, the Commission has determined to include only those foreign advisers who are subject to regulation by a foreign regulator or self-regulatory organization (''SRO'') that either (1) operates under a regulatory framework that has been found by the Commission to be comparable to that in the United States and has been issued a Commission Order under Regulation 30.10 or (2) has entered into a Memorandum of Understanding (''MOU'') or other arrangement for cooperative enforcement and information sharing with the Commission (hereafter referred to as a ''foreign authority'').

In addition, as discussed below in final rule paragraph 1.35(a–1)(5)(iv), the Commission is adding a certification requirement that must be met in order for a foreign adviser to be an eligible account manager. The foreign authority must certify that (1) the foreign adviser's activities are subject to regulation by that foreign authority and (2) the foreign authority will provide, upon request of the Commission or Department of Justice, information that relates to the foreign adviser's compliance with this rule. The Commission believes that restricting foreign advisers who may be eligible account managers in this manner, in combination with the certification requirement, will help facilitate the detection and deterrence of fraud, money laundering or other abusive financial schemes.

The Commission is not including as eligible account managers investment advisers exempt from SEC registration under Section 203(b)(3) of the Investment Advisers Act of 1940 or CTAs exempt from Commission registration under Section 4m(1) of the Act. These entities are not examined in the ordinary course of audits conducted by the SEC or NFA, respectively.

C. Eligible Customers

1. Proposed Regulation 1.35(a–1)(5)(iii)

(a). 1.35(a–1)(5)(iii)(A)—Types of Customers. The 1998 proposal provided that eligible orders could be placed on behalf of, and allocated to, accounts owned by an identified group of entities (''eligible customers'') which has consented in advance and in writing to the account manager that orders could be placed, executed, and allocated in accordance with the eligible order procedures.[25] Except for the exclusion of sole proprietorships, natural persons, floor brokers, floor traders, and self-directed employee benefit plans, the group of eligible customers was substantially similar to those entities defined as ''eligible participants'' for purposes of Part 36—Exemption of section 4(c) Contract Market Transactions, of the Commission's regulations.[26] Having previously considered this group of entities and determined that they are eligible to participate both in exempt transactions and in swaps, the Commission determined that they are sufficiently sophisticated to monitor the results of any post-execution allocations in their accounts.

Accounts owned by sole proprietorships, floor brokers, floor traders, natural persons, and self-directed employee benefit plans were not included as eligible customers.

(b). 1.35(a–1)(5)(iii)(B)—Proprietary Interest. The 1998 proposal provided that the following persons, or any combination thereof, could not have an interest of ten percent or greater in any account that received any part of an eligible order:

(i) the account manager,

(ii) the futures commission merchant allocating the order;

(iii) Any general partner, officer, director, or owner of ten percent or more of the equity interest in the account manager or the futures commission merchant allocating the order;

(iv) Any employee, associated person, or limited partner of the account manager or the futures commission merchant allocating the order who affects or supervises the handling of the order;

(v) Any business affiliate that, directly or indirectly, controls, is controlled by, or is under common control with, the account manager or the futures commission merchant allocating the order, or

(vi) Any spouse, parent, sibling, or child of the foregoing person.

The limitation to less than ten percent ownership interests in any account that received any part of an eligible order was intended to balance the potential for misallocation with the recognition that there are situations where proprietary accounts should be permitted in a bounded order. For example, the Commission was aware that proprietary accounts might properly be included with customer accounts in a bunched order where the account manager had ''seed'' money invested in an account or where the account manager invested in an account in order to attract other investors. In addition, a complete prohibition on any interest in an included account would exclude certain publicly owned organizations from becoming eligible customers and thus would result in unfair customer treatment.

2. Comments Received

(a) 1.35(a–1)(5)(iii)(A)—Types of Customers. All commenters addressing eligible customers suggested that the list be expanded to include natural persons.[27] CBT and CSCE commented that the list should be expanded to include floor brokers and traders. MFA suggested that all eligibility restrictions should be eliminated.

Several commenters also suggested that the Commission should not create yet another definition of ''sophisticated customer.''[28] Thus, CME and CBT proposed that the list of eligible customers should be consistent with the list of ''eligible participants'' in Part 36; CME, CBT, and MFA proposed that it should be consistent with the list of ''eligible swap participants'' in Part 35; and MFA proposed that it should be

[24] A foreign advisor who places orders on U.S. futures exchanges for U.S. persons would be required to register as a CTA and, thus, would be included as an eligible account manager when placing bunched orders for eligible customers.

[25] The issue of customer consent was discussed above. As noted, the Commission is eliminating the consent requirement, but including disclosure requirements to assure the customer is apprised of, among other things, allocation methodology and fairness standards.

[26] As the Commission stated in promulgating the final rules for Part 36, the list of ''eligible participants'' was modeled on the list of ''appropriate persons'' set forth in Section 4(c)(3)(A) through (J) of the Act and on the definition of ''eligible swap participant'' under Part 35 of the Commission's regulations. 60 FR 51328 (October 2, 1995).

[27] NYCE and Man. NFA, CME, CBT, NYMEX, and CSCE commented that natural person as defined in Parts 35 and 36 should be included. MFA stated that natural persons as defined in Part 35 and Regulation 4.7 should be included. NY Bar commented that natural persons meeting the ''qualified eligible client'' criteria defined in Regulation 4.7(b)(1)(ii)(B) should be included. Goldman commented that natural persons meeting the ''qualified eligible participant'' criteria defined in Regulation 4.7 should be included.

[28] NFA, MFA, NY Bar, CME, NYMEX, and CSCE.

consistent with ''qualified eligible client'' under Regulation 4.7.[29]

(b) 1.35(a–1)(5)(iii)(B)—Propriety Interest. Most commenters believed the provision limiting proprietary interest to an interest of less than ten percent was overly restrictive and should be eliminated.[30] NFA and MFA stated that many institutional customers desire that their account managers trade their own funds just like the customers' funds and may, according to MFA, require that the account manger have a significant proprietary interest. It was noted that applying a percentage test to determine eligibility to bunch and allocate orders could prove administratively burdensome.[31] MFA and Goldman stated that the account manager could be subject to potential liability because his or her interest may fluctuate in size over time. ICI commented that it would be very difficult, and in some cases impossible, for an account manager to determine ownership interest and monitor compliance with the ten-percent limitation.[32]

NFA commented that, if the allocation procedures satisfy certain core fairness principles, then it should not matter that proprietary accounts are included in the bunched order. MFA commented that, if the allocation methodology were fundamentally fair, non-preferential, and verifiable, it would be fair for all orders allocated by that methodology. MFA further stated that requiring the account manager to trade a proprietary account outside the bunched order would greatly diminish the effectiveness of the audit process and create complexity and opportunities for misallocations in monitoring, auditing and implementing the separate allocation procedures.[33]

3. Final Regulation 1.35(a–1)(5)(ii)

After consideration of the comments, the Commission has determined to modify the 1998 proposal's list of eligible customers to make it completely consistent with the Part 36 list of ''eligible participants.''[34] Thus, the Commission is including as eligible customers natural persons, subject to the Part 36 total asset requirement, and floor brokers and traders.[35] Likewise, the Commission is removing the 1998 proposal's restriction of self-directed corporate qualified pension, profit sharing, or stock bonus plans subject to Title 1 of ERISA for those plans that satisfy the ''eligible participant'' criteria of Part 36. The Commission believes that these entities are generally capable of understanding bunched order and post-execution allocation procedures and risks. Further, in order to assist the eligible customers in this understanding, the Commission is requiring that the account manager disclose certain specific information to them. These disclosure requirements, discussed in detail in final rule paragraph 1.35(a–1)(5)(iii) below, are designed to apprise the account owner of allocation methodologies, fairness standards, availability of data for comparing returns on investment, and any proprietary accounts that may be included in the bunched order.

The Commission has also determined that it is appropriate to eliminate the less than ten percent restriction on proprietary interest that would have been imposed upon the account manager, the FCM allocating the order, and other listed entities. The Commission is aware that the proposed limitation does not exist in other markets and agrees with the commenters that it would be administratively burdensome and difficult to manage and to enforce. Among other things, the account manager would have a difficult time determining the level of interest held by the total group of possible participants who would be subject to the limitation. That level of interest also would be subject to fluctuation, would require constant monitoring, and could result in inadvertent violations, *e.g.,* when redemption in a fund occurred. The Commission also is aware that the eligible customers may prefer to invest with an account manager who has a significant proprietary interest in the trading activity, *i.e.,* an account manager who puts his or her money at risk along with that of the customer. Finally, the Commission agrees with the commenters who stated that, if the allocation procedures are fair, they remain so even if the account manager has an interest in an included account.

Therefore, the proposed interest limitations have been deleted. In addition, eligible account managers have been included in the list of eligible customers for whom orders may be placed and allocated on a post-execution basis. In order to assure that an eligible customer is aware that an account in which the account manager has an interest may be included with the customer's account in the bunched order, the Commission is requiring, as discussed below, that the account manager disclose his or her policies with regard to this issue.

D. Disclosure—Final Regulation 1.35(a–1)(5)(iii)

As previously noted, the 1998 proposal required that the customer consent, in writing to the use of eligible order procedures, and the proposal placed a less than ten percent interest limitation on proprietary orders that could be included in the bunched order. Because the Commission has concluded that the customer protection intended to be provided by these proposed requirements can be provided as effectively through detailed disclosure, the Commission has determined to substitute disclosure requirements for the proposal's consent requirement and proprietary interest limitation.

These disclosure requirements are based upon comments submitted by NFA and MFA both of which stated that strengthened customer protection could be attained by expanding disclosure requirements. Among other things, NFA proposed that the regulation should require that eligible account managers describe to their customers, in general

[29] NY Bar recommended that the Commission eliminate the fixed total asset requirement applied to commodity pools in order for the pools to meet the eligible customer criteria. The fixed asset level would not address situations where the pool initially met the requirement but subsequently fell to a lower asset level because of investor redemption or trading losses. In the alternative, NY Bar commented that the fixed asset level requirement should be applied only at the inception of trading.

[30] NFA, MFA, NYCE, and Goldman, NY Bar commented that proprietary interest in excess of ten percent should be permitted so long as it is disclosed. CBT commented that the limitation should be clarified to state that an account would not be disqualified from eligibility if from time to time the ten-percent interest test were exceeded on a temporary or marginal basis. This would permit some limited flexibility as the limitation is applied to commodity pool operators or CTAs setting up new pools or liquidating old pools.

[31] NFA, MFA and Goldman.

[32] ICI recommended that interests in registered investment companies be excluded from the limitation or, in the alternative, that it be acceptable for the account manager to certify that it reasonably believes it is in compliance with the requirements of the regulation.

[33] MFA stated that requiring the limitation on proprietary interest could provide an opportunity for dishonest account managers to allocate fraudulently by altering the extent of their proprietary investment or otherwise changing the group of accounts that trade within, rather than outside, the bunched order. Goldman commented that preferential allocations to accounts in which the account manager has a proprietary interest would be more readily apparent and therefore more easily detected if the proprietary accounts were included in the bunched order.

[34] As previously noted, the Commission has considered this group of entities and determined that they are eligible to participate both in transaction under the Part 36 pilot program and in swaps and believes that they are sufficiently sophisticated to monitor the results of any post-execution allocations in their accounts.

[35] With regard to allocations to accounts owned by natural persons, the Commission believes that the various increased standards applicable to the manner in which account managers will be required to handle these accounts should mitigate the Commission's previously stated concerns.

terms, their basic approach to allocating trades among participants in a particular trading program. NFA stated that the account manager should be required to represent to eligible customers that it regularly reviews each account to assure that the allocation methodology has been fair and equitable and that it will document the internal procedures and results of its regular analysis and maintain these procedures and results as firm records.[30]

MFA commented that the account manager should be required to disclose to the customer the nature of its allocation methodology and the fairness standard required of the methodology, the ability of the customer to request confirmation regarding the operation of the methodology, and the extent to which the account manager includes accounts in which it has an interest in the bunched order. According to MFA, requiring that disclosure to the customer include this information would assure that the customer would be able to provide informed consent to participation in the bunched order and fair allocation procedures.

The Commission has drawn upon these NFA and MFA comments to craft the disclosure requirements found in the final regulation and described below. The Commission believes that compliance with these requirements will assure that the customer is armed with adequate knowledge of the bunched order and post-execution allocation procedures as they apply to his or her account and thus will have an enhanced ability effectively to monitor account activity. Thus, these disclosure requirements are an appropriate substitute for the written customer consent requirement and less than ten-percent proprietary interest limitation.

Before placing the initial order eligible for post-execution allocation, the account manager must disclose the following to each of its customers to be subject to post-execution allocation:

(i) The general nature of the allocation methodology the account manager will use;

(ii) The standard by which the account manager will judge the fairness of allocations;

(iii) The ability of the customer to review summary or composite data sufficient for that customer to compare its results with those of other relevant customers;[37] and

(iv) Whether accounts in which the account manager may have any interest may be included with customer orders in orders eligible for post-execution allocation.

E. Account Certification

1. Proposed Regulation 1.35(a–1)(5)(iv)

In 1998 proposal required that, before placing the initial eligible order, the account manager certify in writing to each FCM executing and/or allocating any part of the order that the account manager was aware of the eligible order provisions and would comply with those provisions. Further, the account manager was required to provide each FCM allocating the order with a list of eligible futures accounts.

The certification requirement was designed to assure that the account manager, who has overall responsibility for compliance with the eligible order provisions, was cognizant of, and would comply with, the provisions. The certification requirement would need to be made only once to each applicable FCM, and not on an order-by-order basis.[38] The extent of the account manager's compliance with these requirements would be determined during audits and on a for-cause basis.

2. Comments Received

Commenters addressing the certification issue generally made two suggestions. First, the certification should be made only to the clearing FCM;[39] and second, the certification should remain in effect unless revoked.[40] With regard to the requirement that the account manager provided a list of eligible futures accounts, ICI commented that, rather than requiring a cumulative list, the Commission should permit an account manager to provide the FCM with eligibility information on an account either when it is opened or once a determination is made that it is an eligible account for purposes of the regulation.[41]

3. Final Regulation 1.35(a–1)(5)(iv)

After consideration of the comments received, the Commission has determined that the account manager certification need be provided only to the FCM clearing any part of an order eligible for post-execution allocation to the ultimate customers. Further, this certification, once made, will continue in effect until the account manager revokes it or the FCM is otherwise notified of a change.

With regard to the identification of the eligible customer accounts, the Commission agrees that a list of the accounts need not be required. Rather, the Commission has determined to require only that the account manager must identify these accounts to the FCM clearing any part of an order eligible for post-execution allocation. Identification may be accomplished by list; by notice at the opening of the account; by letter if the determination is made after the account is open; or by other, similar method. The Commission continues to believe that the requirement that the account manager identify the eligible customer accounts to the FCM should enable the FCM to insure that allocations are made only to those eligible customer accounts.[42]

Finally, in order to facilitate compliance with the requirements of this rule, as well as to facilitate the detection and deterrence of fraud, money laundering and other abusive

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[30] As discussed below, NFA strongly supported the proposed requirement that each account manager make available data sufficient for customers to compare their results with those of other relevant customers.

[37] Of course, the account manager would be expected to disclose the customer's ability to compare its results with those of similarly traded accounts in which the account manager has an interest, if such accounts are included. In those circumstances, the accounts in which the account manager has an interest would be accounts "of other relevant customers."

[38] Where the account manager places orders directly with a floor broker rather than an executing FCM, the certification would have to be filed only with each FCM allocating any part of an eligible order and not with the floor broker.

[39] NFA, NYMEX, and Goldman, MFA suggested that the certification be made either to the clearing FCM or to the NFA. NFA also commented that the term "represent" should be used in place of "certify."

[40] NFA, CBT, and NYMEX.

[41] Man commented that the failure of an account manager to inform the FCM of any deviations or changes to the list of eligible accounts, as well as the potentially large number of accounts which may be on the list, could result in potential errors and delays in trade processing. The responsibility for fair, non-preferential allocation of orders among accounts is that of the account manager and not the FCM. Obviously, whether or not a list was provided to the FCM, an FCM has an ongoing obligation to inquire if there are appearances of preferential allocations. Thus, Man proposed that the requirement to provide a list of eligible futures accounts to the FCM not be required since it serves no meaningful purpose.

[42] The account manager must notify the clearing FCM when the account manager has notice that a previously identified eligible account is no longer eligible to be included in bunched orders allocated on a post-execution basis. However, if the account manager has a reasonable basis to believe that the account will regain its eligibility status within 10 business days, the account manager need not notify the FCM and may continue to treat that account as an eligible account. This timeframe is consistent with the maximum of 10 business days which may be granted by the Commission, in its discretion, to allow an FCM or IB to achieve compliance with the § 1.17 net capital requirements without having to transfer accounts and cease doing business. Thus, although a commodity pool would no longer be an eligible account if its total assets fell below the $5,000,000 threshold because of investor redemptions or trading losses, the account manager may continue to treat that commodity pool as an eligible customer account if the account manager has a reasonable basis to believe that the reduction in assets is temporary and that the commodity pool's total assets will be increased to the $5,000,000 within 10 business days.

financial schemes, the Commission has determined that an additional certification requirement is appropriate. Foreign advisers must also provide to each FCM clearing any part of an order eligible for post-execution allocation a written certification from a foreign authority that (1) the foreign adviser's activities are subject to regulation by that foreign authority and (2) the foreign authority will provide, upon request of the Commission or Department of Justice, information that relates to the foreign adviser's compliance with this rule.

F. Allocation

1. Proposed Regulation 1.35(a–1)(5)(v)

The 1998 proposal required that the account manager and the clearing FCM allocate the order to eligible participating customer accounts prior to the end of the day the order is executed. Further, the proposal required that allocations be fair and nonpreferential, taking into account the effect on each relevant portfolio in the bunched order. These allocation requirements were designed to assure that allocations were made fairly, in a timely manner, and only to eligible customer accounts.

As stated in the 1998 proposal, although the account manager has the responsibility for employing a system that results in fair, equitable, and non-preferential allocations, the FCM does assume some responsibility with regard to the fairness of the allocations.[43] If the FCM were directed to allocate eligible orders to previously unidentified accounts or became aware of what appeared to be preferential allocations, the FCM would be required to make a reasonable inquiry and, if appropriate, to refer the matter to the appropriate regulatory authority.

2. Comments Received

Among the comments received that addressed the allocation requirements, NFA stated that it would be helpful to indicate that account managers should provide allocation information as soon as practicable after the entire transaction is executed but no later than the end of the day. Further, NFA suggested that the Commission clarify that ''end of the day'' might be defined by certain contract market or FCM operational timetables.[44] MFA commented that order allocation should be required no later than the deadline for the submission of trade data established by the exchange on which the trade is made.

Two commenters expressed concerns regarding allocation responsibilities proposed to be imposed on the FCMs. NY Bar commented that the requirement that the FCM conduct reasonable inquiry and refer to regulatory authorities any situations in which an order allocation formula appears to be abandoned or significantly departed from poses an unreasonable burden upon the FCM. In a similar vein, CBT commented that it is unnecessary to require the FCMs to have responsibilities above and beyond those already placed on them to ensure fair and equitable treatment of their customers by Regulation 166.3, which requires that FCMs diligently supervise the handling of customer accounts.

Finally, NFA suggested that among the representations that the eligible account manager should be required to make to his or her customers is that the allocation methodology will be: (1) Non-preferential, so that no account or group of accounts receive consistently favorable or unfavorable treatment; (2) sufficiently objective and specific that the appropriate allocation for a given trade can be verified in an independent audit; and (3) consistently applied.

3. Final Regulation 1.35(a–1)(5)(v)

After consideration of the comments received, the Commission has determined to modify the timeliness and fairness standards and to add as allocation requirements the NFA's proposed representations regarding the allocation methodology. The requirement that allocations must be made only to the accounts of eligible customers is being retained.

With regard to the timeliness of the allocations, the Commission is revising the standard to require that allocations must be made as soon as practicable after the entire transaction is executed, but no later than the end of the day the order is executed.[45] The Commission is aware of no reason to postpone the allocations until the end of the day in situations where the results of the entire transaction are already known and fairness to the included accounts can thus be attained without further delay. Although it is no longer separately stated in this paragraph, the Commission continues to believe that the definition of ''end of the day'' for purposes of post-execution allocation may be specified by exchange rule. That provision was removed as an allocation requirement because it was redundant. Paragraph 1.35(a–1)(5) of the final rule already provides that orders eligible for post-execution allocation must be handled in accordance with exchange rules submitted to the Commission pursuant to Section 5a(a)(12)(A) and Regulation 1.41.

The Commission has modified the basic fairness standard of the allocation requirements in two areas. First, the standard in the final rule requires that the allocations must be fair and equitable and that no account or group of accounts may receive consistently favorable or unfavorable treatment.[46] The Commission is aware that the existence of preferential allocations is best determined over a period of time and not on the basis of individual allocations.[47]

Second, since the requirement that there must be a portfolio containing instruments which are either exempt from regulation pursuant to the Commission's regulations or excluded from Commission regulation under the Act has been deleted, the fairness standard no longer refers to ''taking into the account the effect on each relevant portfolio in the bunched order.'' Nonetheless, even without a portfolio requirement, the Commission expects that audits determining the fairness of allocations among accounts will consider all instruments and all transactions relevant to the accounts being audited.

With respect to the account manager's allocation methodology, the Commission has determined to include as an allocation requirement NFA's proposed required representations regarding that methodology. That is, the

[43] As discussed herein, FCM responsibilities regarding the fairness of allocations are those of the clearing FCM.

[44] NFA encouraged the Commission to require that eligible account managers disclose to their customers that they will provide allocation information as soon as practicable after an entire transaction is executed, but no later than as required by certain exchange or FCM operational timetables.

[45] As used herein, the term ''entire transaction'' includes the bunched futures and/or option order(s) and all related transactions executed in all markets for the included accounts.

[46] This requirement is consistent with allocation responsibilities imposed upon banks. Banking regulators require that banks effecting securities transactions for customers establish written policies and procedures for the fair and equitable allocation of securities and prices to the accounts when orders are placed for the same security. *See* 12 C.F.R. § 208.24(g)(2) (1998) (requiring such procedures for state member banks); 12 C.F.R. § 12.7(a)(2) (1998) (requiring such procedures for national banks).

[47] The Commission is also aware that an account in which the account manager has an interest could, on a given day, even using random allocation methodology, receive better allocations than one or more of the included customer accounts. The Commission would not, absent evidence to the contrary, find that this allocation violated the fairness standard so long as the account manager could demonstrate that the results were consistent with the allocation methodology disclosed by the account manager and so long as the favorable allocation is not representative of a pattern of preferential allocation.

allocation standard in the final rule will include a requirement that the account manager's allocation methodology must be (1) sufficiently objective and specific that the allocation for a given trade can be verified in an independent audit and (2) consistently applied.

Finally, the requirement that allocations must be made only to the accounts of eligible customers and must be made in a fair and equitable manner remains as stated in the proposal. The account manager has the responsibility for employing a system that results in fair, equitable, and non-preferential allocations. The FCM generally has the responsibility for complying with instructions from the account manager. The FCM also has additional responsibilities with regard to the allocations. If the account manager were to direct the allocation of fills into an account that has not been identified as an eligible account or if the FCM becomes aware of what appear to be preferential allocations, the FCM is required to make a reasonable inquiry and, if appropriate, to refer the matter to the appropriate regulatory authority, *i.e.,* the Commission, NFA, or the FCM's designated self regulatory organization (''DSRO''). In addition, the FCM must act consistently with its obligations under Regulation 166.3 to supervise diligently the handling of its customer accounts.

G. Recordkeeping

1. Proposed Regulation 1.35(a–1)(5)(vi)

The 1998 proposal required that each eligible order and the account manager placing the order be identified on the order tickets at the time of placement. Each transaction resulting from an eligible order was required to be identified on contract market trade registers, other computerized trade practice surveillance records, and confirmation statements provided to eligible customer accounts. These requirements were designed to assure the existence of a complete audit trail from order placement through order allocation.

The 1998 proposal required that each account manager must make available, upon request of a representative of the Commission or the United States Department of Justice, customer consent documents and records reflecting futures and option transactions, other transactions executed pursuant to the portfolio management strategy, and any other records that would identify the management strategy and relate to, or reflect upon, the fairness of the allocations. Finally, it required that each account manager must make available for review, upon request of an eligible customer, data sufficient for that customer to compare its results with those of other relevant customers, prepared so as not to disclose the identity of individual account holders. The description of the requirement in terms of data was intended to permit the use of established methods used by sophisticated institutional investors in securities to measure and to compare performance. The comparison data could be prepared without requiring the disclosure of the identity of individual account holders.

2. Comments Received

With respect to the requirement that the eligible order and the account manager placing the order must be identified on the office and floor order tickets, NFA suggested that the account manager be identified by code or other appropriate identifier, and CBT questioned the necessity of designating the account manager on the original order tickets. MFA and CBT suggested that the rule should permit the use of a group identifier with respect to the group of accounts to be allocated in the bunched order.[48] MFA and CBT were opposed to the requirement that eligible order transactions be identified on trade registers and other computerized trade practice surveillance records.[49] Several commenters suggested that the requirement that trades be identified on confirmation statements provided to the customer accounts should be deleted.[50] Most of those commenters stated that such a requirement was redundant and unnecessary once the customer has been informed that orders for his or her account would be placed and allocated pursuant to the eligible order procedures.

MFA addressed the requirement that the account manager make certain information available, upon request, to the Commission or the Department of Justice. MFA objected to the requirement that the account manager maintain records demonstrating the relationship between the futures and other transactions. It contended that the eligible order relief should be available without regard to whether there were any other transactions and that the records demonstrating any trading strategy could cause unnecessary disclosure of proprietary trading strategies and procedures. MFA further commented that the rule should be narrowed to require retention only of information essential to the determination of the appropriateness of the allocations made.

Numerous commenters addressed the requirement that comparative data be made available to the customer so that he or she could compare results with those of other relevant customers. NYCE supported the requirement as stated.[51] NFA supported it as modified to define the data required to be made available as ''performance'' data. ICI supported it as modified to define the data as ''aggregated'' or ''composite'' information. MFA recommended that the rule not require disclosure of comparative account information of other customers, but rather disclosure of summary information for the accounts for which such orders are made. NY Bar and CME recommended that the requirement be deleted.[52]

3. Final Regulation 1.35(a–1)(5)(vi)

The Commission has determined to make several revisions to the proposed recordkeeping requirements. In order to provide for a more complete audit trail and consistent with SEC recordkeeping requirements applicable to investment advisers, the Commission is adding a requirement that the account manager, prior to placing the order, create and timestamp a document reflecting the terms of the order and the expected allocation thereof (''order origination document'').[53] Any subsequent decision

[48] In its comment objecting to the proposal's requirement that an eligible order must be identified throughout the execution, clearing, and confirmation procedures, MFA stated that the account manager should be required to identify the orders as eligible orders at the time of entry and on its trade blotter and allocation sheets.

[49] MFA stated that the cost of requiring compliance would be large without achieving any identifiable separate regulatory objective. CBT stated that the requirement would result in excessive cost to the industry and that the benefit of this type of information is questionable.

[50] NFA, MFA, CBT, Goldman, and Man.

[51] NYCE further commented that the data should also be required to be made available to regulatory authorities.

[52] NY Bar recommended, as an alternative, requiring the availability of comparable trading data for audit by the NFA. CME commented that the account manager's primary regulator should impose such a requirement if it determines that such a requirement is necessary.

[53] Among the books and records to be maintained by investment advisers registered or required to be registered under section 204 of the Investment Advisers Act of 1940 are the following:

A memorandum of each order given by the investment adviser for the purchase or sale of any security, of any instruction received by the investment adviser from the client concerning the purchase, sale, receipt or delivery of a particular security, and or any modification or cancellation of any such order or instruction. Such memoranda shall show the terms and conditions of the order, instruction, modification or cancellation; shall identify the person connected with the investment adviser who recommended the transaction to the client and the person who placed such order; and shall show the account for which entered, the date of entry, and the bank, broker or dealer by or through whom executed where appropriate. Orders

to alter the included accounts, proposed allocation, or other terms of the order would likewise be required to be documented and timestamped. The Commission is specifying the information that must be retained, not the type or format of the document on which such information must be recorded. For instance, if an order and its allocation methodology were generated based upon a computer program, a copy of the computer-timed output document might be adequate. If an order were to be allocated according to a standardized methodology described in a pre-existing document, the timestamped order origination document need only reflect the terms of the order and a reference to the allocation methodology in that document, or to the document, as appropriate. The basic requirement is that the order origination document, which must be retained pursuant to Regulation 1.31, must assist an auditor in tracing the allocations attributable to a specific transaction by documenting the origin of that transaction.[54]

With regard to the information required to be identified on the office and/or floor order tickets, the Commission agrees with the commenters that a group identifier or other code would be adequate, so long as the order is identified as an order eligible for post-execution. Thus, the Commission has deleted the requirement that the account manager placing the order must be identified on the order tickets. However, in keeping with the Commission's intention to enhance the ability of an auditor to trace the allocations attributable to a specific transaction, the Commission is also requiring that the group identifier or other code on each order ticket relate back to the specific order origination document described above.[55]

The Commission is retaining the proposed requirement that each transaction executed based upon an order eligible for post-execution allocation be identified on contract market trade registers and other computerized trade practice surveillance records. The Commission continues to believe that this is an important enhancement to the audit trail in that it would permit an order to be tracked throughout its processing.[56] However, the Commission agrees with the commenters that the proposed requirement that the transactions must also be identified on confirmation statements provided to eligible customer accounts is unnecessary. Once the eligible customers have been informed that orders for their accounts will be placed and allocated as orders eligible for post-execution allocation, the trades need not be identified separately on confirmation statements.

The proposed requirement that records be made available, upon request, to the Commission and Department of Justice has been retained, but modified to comport with other revisions to the 1998 proposal. The reference to consent documents has been revised to refer to disclosure documents, and the reference to the portfolio management strategy has been deleted. The requirement that records be made available to a customer for that customer to compare its results with those of other relevant customers has also been retained, but modified. As suggested by commenters, the provision specifies ''summary'' or ''composite'' data. The Commission believes that this revision should allay concerns that the disclosure of comparative account information might lead to the identification of a particular customer.[57]

H. Contract Market Rule Enforcement Programs

1. Proposed Regulation 1.35(a–1)(5)(vii)

The 1998 proposal required that, as part of its rule enforcement program, each contract market that adopted rules allowing the placement of eligible orders must adopt audit procedures to determine compliance with certain account certification, allocation, and recordkeeping requirements.

This surveillance requirement, to be met by the exchange as part of its routine oversight of member firms, was deemed necessary to deter possible unlawful activity and to ensure that an adequate audit trail existed for eligible orders. Under the proposal, the contract market was required to adopt audit procedures to determine compliance with (1) the certification requirements; (2) the requirement that orders must be allocated to eligible accounts by the end of the day; and (3) the requirement that eligible orders must be identified on order tickets, trade registers, other surveillance records, and customer confirmation statements.

2. Comments Received

CBT and CSCE commented adversely on the audit procedures proposed to be required by exchanges. CBT commented that the responsibility for the surveillance of account managers seems to be appropriately placed on the NFA rather than on the exchange on which the trades are transacted. Thus, CBT argued that it would be duplicative and unduly burdensome to require exchanges to conduct specific regulatory reviews of these types of accounts as part of the regulations. CSCE commented that many of the areas required to be reviewed pertained to back-office FCM activities, which would fall within the scope of the review conducted by the FCM's DSRO and which would not be part of each exchange's rule enforcement program. Thus, according to CSCE, the only areas that would be subject to audit under an exchange rule enforcement program would be the requirement that eligible order transactions be identified on floor orders, exchange trade registers and other trade practice surveillance records.

3. Final Regulation 1.35(a–1)(5)(vii)

The Commission continues to believe that oversight of these areas should be required. However, in response to the comments, the Commission has

entered pursuant to the exercise of discretionary power shall be so designated. 17 C.F.R. § 275.204–2(a)(3) (1997).

Registered investment companies are also required to maintain records. Section 31(a) of the Investment Company Act of 1940 and Rule 31a–1(b)(5) thereunder require that registered investment companies maintain a current record of each brokerage order for securities, whether executed or unexecuted, showing, among other things, the terms and conditions of the order, the time of order entry or cancellation and the time of receipt of report of execution. 17 C.F.R. § 270.31a–1(b)(5) (1997). Rule 31a–1(b)(6) applies the Rule 31a–1(b)(5) recordkeeping requirements to all other portfolio purchases or sales, such as futures transactions. 17 C.F.R. § 270.31a–1(b)(6) (1997).

With regard to permissible procedures for bunching orders and allocating trades in securities, including the preparation of allocation documentation prior to order placement, *see* SMC Capital, Inc. SEC no-action letter (available September 5, 1995) and Pretzel & Stouffer SEC no-action letter (available December 1, 1995). Finally, as previously noted, MFA commented that the account manager should be required to identify orders eligible for post-execution as such at the time of entry and on its trade blotter and allocation sheets. *See* n. 48.

[54] Of course, the account manager must create and retain a record reflecting the participation of all accounts in each order eligible for post-execution allocation, including the allocations.

[55] If the account manager places multiple orders to satisfy the investment criteria documented on the order origination document, each of the order tickets must contain the group identifier or other code that relates back to that specific order origination document.

[56] Because of the potential for misallocation, each exchange should routinely monitor the placement, execution, and allocation of orders eligible for post-execution allocation as part of its trade practice surveillance program.

[57] Additionally, as previously stated, the account manager would be required to disclose to a customer that customer's ability to review composite or summary data sufficient for that customer to compare its results with those of similarly traded customers, including similarly traded accounts in which the account manager has an interest. Thus, the specific amount and extent of information to be provided could be determined by agreement between the account manager and his or her customer.

modified the responsibilities identified by the 1998 proposal as part of an exchange's rule enforcement program. Audit of the recordkeeping requirements pertaining to data on exchange computerized records and entry data required on order tickets will remain as a responsibility of an exchange's rule enforcement program.[58] Audit of certain of the certification, allocation, and recordkeeping requirements that pertain to the FCM will be a responsibility of the DSRO of the member firm. Thus, during its audit of a member firm, the DSRO will be required to determine that (1) the account manager's certification document is on file; (2) eligible customer accounts are identified; (3) allocations are made to eligible customer accounts; and (4) allocations are made by the end of the day the order is executed. Routine audit of the requirements that pertain to the account manager, such as fairness and adequacy of disclosure, remains the responsibility of the regulatory entity required to perform oversight of the account manager. The NFA, for instance, has the responsibility to perform routine oversight over member CTAs. Of course, the Commission has the authority to determine compliance with all of the rule's requirements and to conduct investigations as appropriate.

III. Conclusion

Subject to certain core regulatory protections, the Commission's final regulation permits certain regulated account managers to place orders for a defined group of eligible customers without providing specific customer account identifiers at the time of order placement or upon report of execution.[59] The commission previously has identified the listed customers as eligible to enter Part 35 swap agreements or to execute Part 36 contract market transactions. The account managers would be required to allocate the order as soon as practicable after the entire transaction is executed, but no later than the end of the day.[60] As discussed below, in addition to the customer safeguards being imposed, significant existing and new audit trail and recordkeeping requirements would remain applicable.[61]

Under the regulation, the account manager must disclose to the customer that orders may be placed, executed, and allocated as orders eligible for post-execution allocation. The account manager also must disclose the general nature of the allocation methodology that will be used and the standard by which the account manager will judge the fairness of the allocations. Allocations must be fair and equitable, so that no account or group of accounts may receive consistently favorable or unfavorable treatment.[62] The allocation methodology must be consistently applied and must be sufficiently objective and specific so that the appropriate allocation for a given trade can be verified in an independent audit.[63]

The account manager would be required to maintain records that would, among other things, reflect futures and option transactions and that would relate to, or reflect upon, the fairness of the allocations. These records would be available, upon request, to the Commission or the Department of Justice. The account manager also would be required to provide the customer, upon request, with summary or composite data sufficient for that customer to compare results with those of other similarly traded customers. The account manager would be required to disclose to the customer that customer's ability to obtain and review the comparative data.

The rule requires that an account manager disclose to customers whether accounts in which the account manager has any interest may be included with customer accounts in bunched orders eligible for post-execution allocation. In addition, the recordkeeping requirements would deter and facilitate detection of misallocations, which may indirectly benefit the account manager.[64] The regulation also requires that an exchange that permits the placement, execution, and allocation of orders eligible for post-execution allocation must adopt, as part of its rule enforcement program, audit procedures to determine compliance with relevant recordkeeping provisions. The exchange, or the DSRO of a member firm clearing orders eligible for post-execution allocation, must adopt audit procedures to determine compliance with relevant certification, allocation, and recordkeeping requirements.

Under the regulation, the account manager must, prior to order placement, create and timestamp an order origination document reflecting the terms of the order and the expected allocation of fills received. Any subsequent change to the terms or allocation must likewise be documented and timestamped. These documents must be retained under the Commission's record retention regulation. The order must be identified as an order eligible for post-execution allocation by group identifier or other code at the time of placement on the floor order ticket and, if appropriate, on the office order ticket. The group identifier or other code on the order tickets must relate back to the order origination document. All trades resulting from the execution of an order must be identified on exchange trade

[58] The exchange, as part of its rule enforcement program, would be expected to examine the order tickets for the presence of identifiers that would (1) indicate that the order was eligible for post-execution allocation and (2) relate back to the order origination document. The exchange would not be required to determine the validity of the identifier that related back to the order origination document.

[59] The Commission appreciates the views of the law enforcement authorities that commented on the previous proposals and shared their desire that Commission-regulated futures and option markets not be used as a vehicle to commit serious financial crimes. It is with those concerns in mind that the Commission has crafted the protections incorporated into the final regulation. These protections include specific eligibility requirements for account managers and customers, as well as disclosure, allocation and recordkeeping provisions intended to document fair and non-preferential treatment of customers. Coupled with the strong antifraud provisions of the Act and the Commission's rigorous supervision rule, these protections should insure that the proposed allocation procedure would not unduly threaten customer protection or market integrity. Rather, the rule should enable account managers acting in a fiduciary capacity to handle customer interest without undermining any legitimate customer or law enforcement interests.

[60] As previously noted, end-of-day or post-execution allocation of bunched or block orders is permissible on foreign futures exchanges and in the cash and securities markets. The NYSE has permitted end-of-day allocation of securities block orders since October 1983. Interpretation 88–3 of NYSE Rule 410(a)(3).

[61] NFA commented that the Commission should adopt the rule for a one-year pilot program and then reevaluate its usage with an eye toward expanding its application to other types of customers and making other adjustments deemed appropriate based upon experience. The Commission is satisfied that, based upon its experience with this issue, a pilot program is not necessary. Of course, the Commission retains the right to amend this regulation if actual experience with the rule indicates that modification would be appropriate.

[62] Where applicable, the employing firm of an account manager should have appropriate internal controls in place to address the added discretion that the account manager will be able to exercise pursuant to this regulation.

[63] Pursuant to Regulation 166.3, an account manager's employer, if registered with the Commission, has a duty diligently to supervise his or her activities. Regardless of registration status, a principal could be held liable for an account manager's wrongdoing under Section 2(a)(1)(A) of the Act.

[64] As a matter of state law or federal securities, commodities, and banking law, eligible account managers would have fiduciary responsibility for their investment management activities. Account managers would be subject to Section 4b, the general antifraud provision of the Act. Account managers who are also acting as CTAs or commodity pool operators (''CPO''), irrespective of registration status, would also be subject to Section 4o. Account managers who place orders for option contracts would also be subject to Commission Regulations 32.9 and 33.10, that prohibit fraud in connection with commodity option transactions.

registers and computerized trade practice surveillance records.

Those requirements, in conjunction with existing audit trail requirements, should enable the Commission, other regulatory agencies, and self-regulatory organizations to track any eligible order from time of placement to allocation of fills. At the time of placement, the order would be identified on the order origination document and on order tickets. These order tickets would be timestamped upon receipt of the order. The order executions would be identified on trading cards and/or order tickets and on exchange trade registers by, among other things, both time and price. The order tickets would be timestamped again to identify time of report of execution. The subsequent allocation of the fills would be maintained on FCM and exchange records. Thus, an auditor could determine, among other things, the size and time of initial order placement, the times and prices of executions, the identities of accounts to which the fills were allocated, and the prices and quantities of the fills allocated thereto.

Based on the foregoing, the Commission believes that this rule strikes an appropriate balance between regulatory protection and regulatory relief.

IV. Other Matters

A. Regulatory Flexibility Act

The Regulatory Flexibility Act (''RFA''), 5 U.S.C. 601 et seq., requires that agencies consider the impact of rules on small businesses. The Commission has previously determined that contract markets,[65] FCMs,[66] registered CPOs,[67] and large traders[68] are not ''small entities'' for purposes of the RFA. The Commission has previously determined to evaluate within the context of a particular rule proposal whether all or some CTAs should be considered ''small entities'' for purposes of the RFA and, if so, to analyze the economic impact on CTAs of any such rule at that time.[69] CTAs who would place orders eligible for post-execution allocation pursuant to these procedures would do so for multiple clients and would be participating as investment managers for a sophisticated group of eligible customers. Accordingly, the Commission does not believe that CTAs should be considered ''small entities'' for purposes of this regulation. Similarly, the Commission does not believe that foreign advisers placing orders pursuant to these procedures on behalf of sophisticated foreign investors should be considered ''small entities'' for purposes of this regulation.

Therefore, the Chairperson, on behalf of the Commission, hereby certifies, pursuant to 5 U.S.C. 605(b), that the action taken herein will not have a significant economic impact on a substantial number of small entities.

Regulation 1.35(a–would provide relief from individual account identification requirements, thereby providing those small entities who qualify and elect to use the relief with a less burdensome method for satisfying Commission Regulation 1.35 requirements.[70]

B. Paperwork Reduction Act

When publishing final rules, the Paperwork Reduction Act of 1995 (Pub. L. 104–13 (May 13, 1995)) imposes certain requirements on federal agencies (including the Commission) in connection with their conducting or sponsoring any collection of information as defined by the Paperwork Reduction Act. In compliance with the Act, this final rule informs the public of:

(1) The reasons the information is planned to be and/or has been collected; (2) the way such information is planned to be and/or has been used to further the proper performance of the functions of the agency; (3) an estimate, to the extent practicable, of the average burden of the collection (together with a request that the public direct to the agency any comments concerning the accuracy of this burden estimate and any suggestions for reducing this burden); (4) whether responses to the collection of information are voluntary, required to obtain or retain a benefit, or mandatory; (5) the nature and extent of confidentiality to be provided, if any; and (6) the fact that an agency may not conduct or sponsor, and a person is not required to respond to, a collection of information unless it displays a currently valid OMB control number.

The Commission has previously submitted this rule in proposed form and its associated information collection requirements to the Office of Management and Budget. The Office of Management and Budget approved the collection of information associated with this rule on March 14, 1998, and assigned OMB control number 3038–0022 to the rule. The burden associated with this entire collection, including this final rule, is as follows:

Average burden hours per response—3609.26
Number of Respondents—15,691.00
Frequency of Response—On Occasion

The burden associated with this specific proposed rule is as follows:

Average burden hours per response—0.5
Number of Respondents—400.00
Frequency of Response—On Occasion

Persons wishing to comment on the information required by this final rule should contact the Desk Officer, CFTC, Office of Management and Budget, Room 10202, NEOB, Washington, DC 20503, (202) 395–7340. Copies of the information collection submission to OMB are available from the CFTC Clearance Officer, 1155 21st Street, NW, Washington, DC 20581, and (202) 418–5160.

List of Subjects in 17 CFR Part 1

Brokers, Commodity futures, Commodity options, Commodity trading advisors, Commodity pools, Consumer protection, Contract markets, Customers, Designated self-regulatory organizations, Futures commission merchants, Members of contract markets, Noncompetitive trading, Reporting and recordkeeping requirements, Rule enforcement programs.

In consideration of the foregoing, and pursuant to the authority contained in the Commodity Exchange Act and, in particular, Sections 5, 5a, 5b, 6(a), 6b, 8a(7), 8a(9) and 8c, 7 U.S.C. 7, 7a, 7b, 8(a), 8b, 12a(7), 12a(9), and 12c, the Commission hereby amends Part 1 of Chapter I of Title 17 of the Code of Federal Regulations as follows:

PART 1—GENERAL REGULATIONS UNDER THE COMMODITY EXCHANGE ACT

1. The authority citation for Part 1 continues to read as follows:

Authority: 7 U.S.C. 1a, 2, 2a, 4, 4a, 6, 6a, 6b, 6c, 6d, 6e, 6f, 6g, 6h, 6i, 6j, 6k, 6l, 6m, 6n, 6o, 6p, 7, 7a, 7b, 8, 9, 12, 12a, 12c, 13a, 13a–1, 16, 16a, 19, 21, 23 and 24.

2. Section 1.35 is amended by revising paragraphs (a–1)(1), (a–1)(2)(i), and (a–1)(4) and by adding paragraph (a–1)(5) to read as follows:

§ 1.35 Records of cash commodity, futures, and option transactions.

* * * * *

(a–1) * * *

(1) Each futures commission merchant and each introducing broker receiving a customer's or option customer's order shall immediately upon receipt thereof prepare a written record of the order including the account identification, except as provided in paragraph (a–1)(5) of this section, and order number, and shall record thereon, by timestamp or

[65] 47 FR 18618, 18619 (April 30, 1982).

[66] *Id.*

[67] *Id.* at 18620.

[68] *Id.*

[69] *Id.*

[70] The Commission received no comments addressing its conclusions with regard to the RFA.

other timing device, the date and time, to the nearest minute, the order is received, and in addition, for option customers' orders, the time, to the nearest minute, the order is transmitted for execution.

(2)(i) Each member of a contract market who on the floor of such contract market receives a customer's or option customer's order which is not in the form of a written record including the account identification, order number, and the date and time, to the nearest minute, the order was transmitted or received on the floor of such contract market, shall immediately upon receipt thereof prepare a written record of the order in nonerasable ink, including the account identification, except as provided in paragraph (a–1)(5) of this section or appendix C to this part, and order number and shall record thereon, by timestamp or other timing device, the date and time, to the nearest minute, the order is received.

* * * * *

(4) Each member of a contract market reporting the execution from the floor of the contract market of a customer's or option customer's order or the order of another member of the contract market received in accordance with paragraphs (a–1)(2)(i) or (a–1)(2)(ii)(A) of this section, shall record on a written record of the order, including the account identification, except as provided in paragraph (a–1)(5) of this section, and order number, by timestamp or other timing device, the date and time to the nearest minute such report of execution is made. Each member of a contract market shall submit the written records of customer orders or orders from other contract market members to contract market personnel or to the clearing member responsible for the collection of orders prepared pursuant to this paragraph as required by contract market rules adopted in accordance with paragraph (j)(1) of this section. The execution price and other information reported on the order tickets must be written in nonerasable ink.

(5) Orders eligible for post-execution allocation. Specific customer account identifiers for accounts included in bunched orders need not be recorded at time of order placement or upon report of execution if the requirements of this paragraph are met. The bunched order must be placed by an eligible account manager on behalf of eligible customer accounts and must be handled in accordance with contract market rules that have been submitted to the Commission pursuant to Section 5a(a)(12)(A) of the Act and § 1.41.

(i) Eligible account managers. The person placing and directing the allocation of an order eligible for post-execution allocation must be one of the following who has been granted investment discretion with regard to eligible customer accounts:

(A) A commodity trading advisor registered with the Commission pursuant to the Act;

(B) An investment adviser registered with the Securities and Exchange Commission pursuant to the Investment Advisers Act of 1940;

(C) A bank, insurance company, trust company, or savings and loan association subject to federal or state regulation; or

(D) A foreign adviser who provides advice solely to foreign persons and who is subject to regulation by a foreign regulator or self-regulatory organization that has been granted an exemption pursuant to § 30.10 of this chapter or has entered into a Memorandum of Understanding or other arrangement for cooperative enforcement and information sharing with the Commission (for the purposes of this section, referred to as a ''foreign authority''), provided that the certification required by paragraph (a–1)(5)(iv)(C) of this section is made.

(ii) *Eligible customers.* The accounts for which orders eligible for post-execution allocation may be placed and to which fills may be allocated must be owned by the following entities:

(A) A bank or trust company;

(B) A savings and loan association or credit union;

(C) An insurance company;

(D) An investment company subject to regulation under the Investment Company Act of 1940 (15 U.S.C. 80a–1, *et seq.*) or a foreign investment company performing a similar role or function subject to foreign regulation, *provided* that the investment company has total assets exceeding $5,000,000;

(E) A commodity pool formed and operated by a person subject to regulation under the Act or a foreign entity performing a similar role or function subject to foreign regulation, *provided* that the commodity pool or foreign entity has total assets exceeding $5,000,000;

(F) A corporation, partnership, proprietorship, organization, trust, or other entity, *provided* that the entity has either a net worth exceeding $1,000,000 or total assets exceeding $10,000,000;

(G) An employee benefit plan subject to the Employee Retirement Income Security Act of 1974 or a foreign entity performing a similar role or function subject to foreign regulation, with total assets exceeding $5,000,000 or whose investment decisions are made by a bank, trust company, insurance company, investment adviser subject to regulation under the Investment Advisers Act of 1940 (15 U.S.C. 80b–1, *et seq.*) or a commodity trading advisor subject to regulation under the Act;

(H) Any government entity (including the United States, any state, or any foreign government) or political subdivision thereof, or any multinational or suparnational entity or any instrumentality, agency, or department of any of the foregoing;

(I) A broker-dealer subject to regulation under the Securities Exchange Act of 1934 (15 U.S.C. 78a, *et seq.*) or a foreign person performing a similar role or function subject to foreign regulation, acting on its own behalf:

(J) A futures commission merchant, floor broker, or floor trader subject to regulation under the Act or a foreign person performing a similar role or function subject to foreign regulation, acting on its own behalf;

(K) An eligible account manager, as defined in paragraph (a–1)(5)(i) of this section; or

(L) Any natural person with total assets exceeding $10,000,000.

(iii) *Disclosure.* Before placing the initial order eligible for post-execution allocation, the account manager must disclose the following to each of its customers to be subject to post-execution allocation:

(A) The general nature of the allocation methodology the account manager will use;

(B) The standard by which the account manager will judge the fairness of allocations;

(C) The ability of the customer to review summary or composite data sufficient for that customer to compare its results with those of other relevant customers; and

(D) Whether accounts in which the account manager may have any interest may be included with customer accounts in bunched orders eligible for post-execution allocation.

(iv) *Account certification.* Before placing an order eligible for post-execution allocation, the account manager must provide the following to each futures commission merchant clearing any part of the order:

(A) If not previously provided, certification, in writing, that the account manager is aware of, and will remain in compliance with, the requirements of this paragraph. This certification shall remain in effect until revoked by the account manager; and

(B) If not previously identified, the identity of each eligible customer account to which fills will be allocated.

(C) Foreign advisers must also provide a written certification from a foreign authority stating that the foreign adviser's activities are subject to regulation by that foreign authority and the foreign authority will provide, upon request of the Commission or Department of Justice, information that relates to the foreign adviser's compliance with the requirements of this paragraph.

(v) *Allocation.* Orders eligible for post-execution allocation must be allocated in accordance with the following:

(A) Allocations must be made only to the accounts of eligible customers.

(B) Allocations must be made as soon as practicable after the entire transaction is executed, but no later than the end of the day the order is executed.

(C) Allocations must be fair and equitable. No account or group of accounts may receive consistently favorable or unfavorable treatment.

(D) The allocation methodology must be sufficiently objective and specific so that the appropriate allocation for a given trade can be verified in an independent audit.

(E) The allocation methodology must be consistently applied.

(vi) *Recordkeeping.* The following recordkeeping requirements apply to orders eligible for post-execution allocation:

(A) Prior to order placement, each account manager must create and timestamp an order origination document reflecting the terms of the order and expected allocation thereof. Any subsequent determination to alter any terms or allocation of the order should likewise be documented.

(B) Each order must be identified by group identifier or other code on the office and/or floor order tickets at the time of placement. The group identifier or other code on each order ticket must relate back to the specific order origination document required by paragraph (a–1)(5)(vi)(A) of this section.

(C) Each transaction must be identified as part of an order eligible for post-execution allocation on contract market trade registers and other computerized trade practice surveillance records.

(D) Each account manager must make available, upon request of any representative of the Commission or the United States Department of Justice, the following records:

(*1*) The disclosure documents required pursuant to paragraph (a–1)(5)(iii) of this section; and

(*2*) Records reflecting futures and option transactions and other transactions and any other records, including the order origination document, that would identify the management strategy or the allocation methodology or would relate to, or reflect upon, the fairness of the allocations.

(E) Each account manager must make available for review, upon request of an eligible customer, summary or composite data sufficient for that customer to compare its results with those of other relevant customers. These summary data may be prepared so as not to disclose the identity of individual account holders.

(vii) *Self regulatory organization rule enforcement and audit procedures.* As part of its rule enforcement program, each contract market that adopts rules that allow the placement of orders eligible for post-execution allocation must adopt audit procedures to determine compliance with the recordkeeping requirements identified in paragraph (a–1)(5)(vi) (B) and (C) of this section. Each contract market, or the designated self-regulatory organization of a member firm, must adopt audit procedures to determine compliance with the certification and allocation requirements identified in paragraphs (a–1)(5)(iv) and (a–1)(5)(v) (A) and (B) of this section.

* * * * *

Issued in Washington, DC on August 21, 1998 by the Commission.

Catherine D. Dixon,

Assistant Secretary of the Commission.

[FR Doc. 98–22933 Filed 8–26–98; 8:45 am]

BILLING CODE 6351–01–M

COMMODITY FUTURES TRADING COMMISSION

17 CFR Part 1

Maintenance of Minimum Financial Requirements by Futures Commission Merchants and Introducing Brokers

AGENCY: Commodity Futures Trading Commission.

ACTION: Final rules.

SUMMARY: Rule 1.12 of the Commodity Futures Trading Commission (Commission or CFTC) [1] sets forth the early warning reporting requirements for futures commission merchants (FCMs) and introducing brokers (IBs). These requirements are designed to afford the CFTC and industry self-regulatory organizations (SROs) sufficient advance notice of a firm's financial or operational problems to take any protective or remedial action that may be needed to assure the safety of customer funds and the integrity of the marketplace.

The Commission is adopting as proposed an amendment to Rule 1.12, applicable to FCMs only, to require immediate notification by an FCM to the CFTC and its designated self-regulatory organization (DSRO) if an FCM knows or should know that it is in an undersegregated or undersecured condition, i.e., that the FCM has insufficient funds in accounts segregated for the benefit of customers trading on U.S. contract markets or has insufficient funds set aside for customers trading on non-U.S. markets to meet the FCM's obligations to its customers. The term "funds" in this context includes accrued amounts due to or from the FCM's clearing organizations and/or carrying brokers in connection with customer-related activities, typically the daily or intraday variation settlement.

The Commission is also adopting amendments to Rule 1.12, as proposed, to require immediate notification of certain events pertaining to undercapitalization or failure to satisfy margin calls, where notice has been required within 24 hours. In addition, the Commission has determined to codify a previous staff interpretation that permits notices required by Rule 1.12 to be filed by facsimile in lieu of telegraphic means and to require immediate telephonic notice as well.

EFFECTIVE DATE: September 28, 1998.

FOR FURTHER INFORMATION CONTACT: Paul H. Bjarnason, Jr., Deputy Director and Chief Accountant, or Lawrence B. Patent, Associate Chief Counsel, Division of Trading and Markets, Commodity Futures Trading Commission, 1155 21st Street, N.W., Washington, D.C. 20581. Telephone (202) 418–5430.

SUPPLEMENTARY INFORMATION:

I. Introduction

On January 6, 1998, the Commission proposed amendments to the early warning requirements set forth in Rule 1.12.[2] These proposals included: (1) a new requirement for an FCM to notify the CFTC and its DSRO immediately (by telephone call to be followed immediately by telegraphic or facsimile notice) when it knows or should know that it is in an undersegregated or undersecured condition; (2) requiring immediate telephonic notice, rather

[1] Commission rules are found at 17 CFR Ch. I (1998).

[2] 63 FR 2188 (Jan. 14, 1998).