September 2, 2011

<u>Via Federal Express</u>

Mr. David A. Stawick
Secretary of the Commission
Commodity Futures Trading Commission
Three Lafayette Centre
1155 21st Street, N.W.
Washington, DC 20581

Re: National Futures Association: Allocation of Bunched Retail Forex Orders for Multiple Accounts – Proposed Adoption of the Interpretive Notice to NFA Compliance Rule 2-10*

Dear Mr. Stawick:

Pursuant to Section 17(j) of the Commodity Exchange Act, as amended, National Futures Association ("NFA") hereby submits to the Commodity Futures Trading Commission ("CFTC" or "Commission") the proposed adoption of the Interpretive Notice to NFA Compliance Rule 2-10 regarding the allocation of bunched retail Forex orders for multiple accounts. NFA's Board of Directors ("Board") approved the proposal on August 18, 2011. NFA respectfully requests Commission review and approval of the proposed amendments.

PROPOSED AMENDMENTS
(additions are <u>underscored</u>)

<u>INTERPRETIVE NOTICES</u>

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<u>NFA COMPLIANCE RULE 2-10:THE ALLOCATION OF BUNCHED RETAIL FOREX ORDERS FOR MULTIPLE ACCOUNTS</u>

<u>NFA Compliance Rule 2-10 adopts by reference CFTC Regulation 1.35, which, among other things, imposes on futures commission merchants ("FCMs") and retail foreign exchange dealers ("RFEDs") certain recordkeeping requirements</u>

relating to customer forex[1] orders. The purpose of the regulation is to prevent various forms of customer abuse, such as the fraudulent allocation of trades, by providing an adequate audit trail that allows customer orders to be tracked at every step of the order processing system. In general, Regulation 1.35 requires FCMs and RFEDs receiving a customer order to prepare a written record of the order immediately upon receipt, including an appropriate account identifier.

With respect to bunched orders placed by a commodity trading advisor ("CTA") on behalf of multiple clients, the CFTC has interpreted Regulation 1.35 to require that, at or before the time the order is placed, the CTA must provide the FCM with information that identifies the accounts included in the bunched order and specifies the number of contracts to be allotted to each account[2, 3] (unless the order is done in accordance with the post-execution allocation of bunched order requirements)[4]. Recent NFA examinations have found that many CTAs who manage retail Forex customer accounts are using a percentage allocation management module ("PAMM") to allocate bunched orders placed by them on behalf of multiple clients.

CTAs utilizing PAMM trade an unlimited number of customer accounts under one "Master Account" at an FCM or RFED. Each individual customer then has a sub-account under the Master Account. CTAs utilize the total equity of the Master Account—the aggregate of all individual customers' funds—to place a bunched order for forex lots or contracts and then subsequently allocate a percentage of the lot(s) or contract(s) to each individual customer's sub-account based on each

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[1] For purposes of the Notice, the term "forex" has the same meaning as in Bylaw 1507(b).

[2] Bunched orders can provide customers with the advantages of better pricing and more efficient execution of orders.

[3] Consistent with the provisions of CFTC Regulation 1.35(a-1)(1), account managers that place orders for a single account must still provide account identification information at the time of order entry.

[4] CFTC Regulation 1.35(a-1)(5)'s language governing the post-execution allocation of bunched orders appears inapplicable to retail Forex bunched orders.

customer's account equity as a percentage of the overall total equity in the Master Account. [5]

If PAMM resulted in the fair and non-preferential allocation of regularly offered and tradable sized lot(s) or contract(s)[6] to each customer's sub-account—and was not based on the customer's account equity as a percentage of the overall total equity in the Master Account—then this method would be consistent with prior interpretations of Regulation 1.35. However, CTAs trading customer accounts and FCMs and RFEDs acting as counterparty to these accounts do not apply PAMM in this manner. Specifically, NFA found that CTAs determine the quantity of regularly offered and tradable sized lots or contracts for a bunched order based on the Master Account's equity, rather than on the quantity of regularly offered and tradable sized lots or contracts that would be permitted based on the margin equity in each individual account, which is often too low to place a trade for a regularly offered and tradable sized lot or contract. Therefore, after the FCM or RFED executes the order, PAMM's application does not result in regularly offered and tradable sized lot(s) or contract(s) being allocated to the individual sub-accounts. Rather, pursuant to PAMM, a percentage of the lot(s) or contract(s) are allocated to each customer based upon their percentage of equity in the Master Account. For example, if two customers had equity that equaled 40% and 12.5% of the Master Account's equity, respectively, then the customers would be allocated .4 and .125 of the regularly offered and tradable sized lot or contract, respectively, if the account manager traded one contract.

The placement of trades based upon the Master Account's total equity and subsequent allocation of a percentage of the lot(s) or contract(s) to individual client accounts pursuant to PAMM, rather than based upon the equity in each individual account causes these individual accounts to be treated similar to a commodity pool's participant units—without the Master Account being legally structured as a commodity pool. Moreover, PAMM leads to certain client

[5] FCMs and RFEDs acting as counterparties to retail Forex customer accounts traded as part of a block order have an obligation to ensure that they have collected and maintained for each individual customer the applicable security deposit requirement pursuant to NFA Financial Requirements Section 12 for each lot or contract placed in a customer's account by a CTA.

[6] Forex positions are often regularly traded in the following lot sizes: Standard (100,000 units), Mini (10,000 units) and Micro (1,000 units). CTAs must discose to their customers the lot size they intend to use.

accounts not being treated fairly and in a non-preferential manner. Specifically, because FCMs and RFEDs are likely to only act as counterparty with respect to the regularly offered and tradable sized lot(s) or contract(s) margined and traded at the Master Account level, PAMM often restricts the ability of account managers to offset an open position in a smaller percentage lot or contract without affecting the positions of all the sub-accounts underlying the Master Account.

NFA also noted that each FCM and RFED that utilizes PAMM imposes varying restrictions applicable to the process by which customers withdraw and add funds to their accounts. In the extreme situation, individual client withdrawal requests are held up indefinitely because the customer's percentage lot open forex position may not be offset until the regularly offered and tradable sized position is offset for all customers at the Master Account level. In another situation, NFA found that if an individual customer is removed from the PAMM module without their open percentage position being offset, then this customer account may not incur a profit or loss for this position and the original regularly offered and tradable lot sized position is simply subsequently reallocated to the remaining sub-accounts thereby immediately increasing the percentage of equity each individual account has in the regularly offered and tradable sized position established based on the Master Account's equity. Due to these restrictions, NFA is concerned that customers may not be able to close their accounts and have timely access to their funds, and customers are not being treated fairly as a result of this trade allocation method.

In summary, CTAs managing retail forex customer accounts may use bunched orders. However, in determining the quantity of lots or contracts for a bunched order, the CTA may not exceed the sum of the quantity of regularly offered and tradable sized contracts that would be permitted based on the equity in each individual account, not the overall equity in the Master Account. In addition, prior to or at the time the CTA places a bunched order with an FCM or RFED, the CTA must inform the FCM or RFED of the number of regularly offered and tradable sized contracts each individual customer account will receive if the order is filled. The CTA must allocate regularly offered and tradable sized lots or contracts to each individual account using a non-preferential predetermined allocation methodology. Further, all customers should be allowed to make additions and withdrawals in a fair and timely manner, and in a manner that does not affect other customers who are managed by the CTA in the same trading program. Given the significant allocation issues with the use of PAMM, NFA at this time is detailing for forex CTAs the longstanding core principles and responsibilities applicable to the allocation of customer bunched orders.

Core Principles and Responsibilities

Allocation instructions for trades made through bunched orders for multiple accounts must address how the total number of contracts should be allocated to the various accounts included in the bunched order. For some CTAs, this allocation may remain relatively constant. For others, although their basic allocation methodology does not change, the specific allocation instructions produced by the methodology may change on a daily basis.

The second issue may be somewhat less applicable to retail forex transactions given the counterparty nature of these transactions but involves the allocation of split or partial fills. For example, a CTA may place a bunched order of 100 contracts for multiple accounts. This order may be either filled at a number of different prices or if an order is to be filled at a particular price the FCM or RFED may be willing to act as counterparty for some but not all of the 100 lot order. In either example, the question arises of how the different prices of the contracts in the split or partial fill should be allocated among the accounts included in the block order.

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

- designed to meet the overriding regulatory objective that allocations are non-preferential and are fair and equitable over time, such that no account or group of accounts receive consistently favorable or unfavorable treatment;[7]

[7] Because customers must have access to information that allows them to assess the fairness of the allocation process, CTAs are required to make the following information available to customers upon request: (1) the general nature of the CTA's allocation methodology; (2) whether accounts in which the CTA may have an interest may be included with customer accounts in bunched orders; and (3) summary or composite data sufficient for that customer to compare its allocation results with the allocation results of other comparable customers and, if applicable, any account in which the account manager has an interest.

- sufficiently objective and specific to permit independent verification of the fairness of the allocations over time and that the allocation methodology was followed for any particular bunched order; and

- timely, in that the CTA must provide the allocation information to FCMs and RFEDs as soon as practicable at the time the order is placed or after the order is filled. [8]

The responsibility for allocating contracts executed through a bunched order rests solely with the CTA.[9] The CTA must confirm, on a daily basis, that all its accounts have the correct allocation of contracts. A CTA must also analyze each trading program at least once a quarter to ensure that the allocation method has been fair and equitable (i.e., customers in the same trading program achieve similar allocation results over time).[10] Allocation fairness over time, rather than trade-by-trade, is the critical element in this evaluation. If materially divergent performance results exist over time among accounts in the same trading program, such results must be shown to be attributable to factors other than the CTA's trade allocation procedures. Applicable CFTC and NFA interpretations have addressed permitted reasons for divergent performance results among accounts in the same trading program. If those results indicate that the allocation method has not been fair and equitable over time, however, then the CTA must

[8] In 1997, NFA adopted *Interpretive Notice 9029-NFA Compliance Rule 2-10: The Allocation of Bunched Orders for Multiple Accounts* and in the Notice set out examples of methodologies for the allocation of bunched orders that generally satisfy the core principles described above. Although these methodologies were set forth with regard to on-exchange futures and options transactions, their application may be equally applicable to retail forex transactions.

[9] However, NFA rules do not preclude an FCM or RFED from agreeing to undertake this responsibility, pursuant to either its own procedures or to those supplied by the CTA. For example, the CTA and FCM or RFED may agree that an FCM or RFED will allocate a bunched order in accordance with instructions that the CTA files with the FCM or RFED either prior to or concurrently with placing the bunched order. Any division of responsibilities agreed to by the FCM and CTA should be clearly documented.

[10] CTAs must review customer performance at the individual client account level and not the master account level. Moreover, CTAs must maintain the necessary records

revise its allocation methodology or adopt a different allocation method for application on a prospective basis only. A CTA must document its internal audit procedures and results and maintain these audit procedures and results as firm records subject to review during an NFA audit.

Although the CTA is responsible for the allocation of each bunched order, FCMs and RFEDs have certain obligations as well. In particular, each FCM and RFED must receive from an account manager sufficient information to allow it to perform its functions, including information concerning the number of contracts to be allocated to each account included in the bunched order along with instructions, if applicable, for the allocation of split and partial fills among accounts. One means by which an FCM or RFED can meet this recordkeeping requirement is to maintain a copy of the allocation instructions provided by the account manager by facsimile, e-mail, or other form of electronic transmission. If the allocation is provided orally, however, the FCM or RFED must create a written record and maintain that record.

Also, if an FCM or RFED has actual or constructive notice that allocations may be fraudulent, the FCM or RFED must take appropriate action. For example, if an FCM or RFED has notice of unusual allocation activity, the FCM or RFED must make a reasonable inquiry into the matter and, if appropriate, refer the matter to the proper regulatory authorities (e.g., the CFTC or NFA or its DSRO). Whether an FCM or RFED has such notice depends upon the particular facts involved.

EXPLANATION OF PROPOSED AMENDMENTS

NFA Compliance Rule 2-10, through incorporation of CFTC Regulation 1.35, requires futures commission merchants (FCMs) and retail foreign exchange dealers (RFEDs) receiving a retail customer Forex order to prepare a written record of the order immediately upon receipt, including an appropriate account identifier. The CFTC has interpreted Regulation 1.35 to require commodity trading advisors (CTAs), at or before the time a bunched order is placed, to provide an FCM with information that identifies the accounts included in the bunched order and specify the number of contracts to be allotted to each account (unless the CTA is using post-allocation procedures permitted under Regulation 1.35).

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and calculate customer performance for each trading program in conformity with the CFTC's Part 4 Regulations.

NFA adopted this Interpretive Notice to Compliance Rule 2-10 to address concerns involving an allocation procedure – known as Percentage Allocation Management Module (PAMM) – that is being used by CTAs that manage retail forex customer accounts when allocating bunched orders placed by them on behalf of multiple clients. CTAs that utilize PAMM place orders at FCMs and RFEDs for an unlimited number of customer accounts under one master account at each FCM or RFED, with each individual customer maintaining a sub-account under the master account. CTAs utilize the total equity of the master account to place a bunched order and then subsequently allocate lots based on each customer's account equity as a percentage of the overall equity in the master account, often resulting in allocations to individual customers that are not equivalent to a regularly offered and tradable sized lot or contract.

As described below, PAMM does not treat each sub-account as an individual account, does not appear to comply with the CFTC's interpretation of Regulation 1.35 and often does not result in the fair and equitable treatment of customer accounts. Specifically:

- CTA's place orders for regularly offered and tradable sized lots or contracts based on the master account's equity and not the margin equity of each individual account. After the FCM or RFED executes the order, PAMM's application in most cases does not result in regularly offered and tradable sized lots or contracts being allocated to individual sub-accounts. Rather, some fraction of a regularly offered and tradable sized lot or contract is allocated to each customer based upon their percentage of equity in the master account.

- Since trades are placed in quantities based upon the master account's total equity rather than in quantities that would be permitted based on the margin equity in each individual account, the customer accounts are treated similarly to a commodity pool's participant units, without the master account being legally structured as a commodity pool.

- Because FCMs and RFEDs generally will only act as a counterparty with respect to regularly offered and tradable sized lots or contracts at the master account level, PAMM often restricts the ability of account managers to offset an individual customer's open fractional position that is not a regularly offered and tradable sized lot or contract without affecting the positions of all the sub-accounts underlying the master account.

- Most FCMs and RFEDs that utilize PAMM impose varying restrictions on customers withdrawing and adding funds to their accounts. In the extreme situation, individual customer withdrawal requests are held up indefinitely because the customer's percentage share of a lot or contract may not be offset until the regularly offered and tradable sized lot or contract is offset for all customers at the master account level. In another situation, if an individual customer is removed from the PAMM methodology without their open fractional share of the lot or contract being offset, that customer's sub-account may not incur the associated profit or loss when the regularly offered and tradable sized lot or contract is offset. Rather, the customer's percentage share of the lot or contract is simply reallocated to the remaining sub-accounts, which immediately increases the percentage of equity each other individual account has in the total lot position. These restrictions inhibit a customer's ability to close their account and have timely access to their funds and do not treat customers fairly with regard to trade allocations.

The proposed Interpretive Notice addresses these issues by clarifying that in order to be in Compliance with CFTC Regulation 1.35 and avoid treating individual customer accounts in a manner similar to a commodity pool participant unit, the CTA must determine the quantity of lots or contracts for a bunched order based on the equity in each individual sub-account and not based on the overall equity of the master account. The CTA must also inform the FDM or RFED, prior to or at the time the CTA places a bunched order, of the number of regularly offered and tradable sized lots or contracts each individual customer will receive if the order is filled based on a predetermined acceptable allocation methodology. Further, all customers should be allowed to make additions and withdrawals in a fair and timely manner that does not affect other customers who are being managed by the CTA in the same program. Finally, the Interpretive Notice reminds Members of the core principles and responsibilities applicable to the allocation of customer bunched orders.

NFA's CPO/CTA Advisory Committee reviewed the proposed Interpretive Notice and supported its adoption. NFA's FDM Advisory Committee felt that CTAs should be permitted to use a fractional lot allocation via PAMM if the FDM was willing to act as the counterparty to that position when the customer decided to offset the position. Staff considered the Committee's recommendation but concluded it did not alone entirely address the issues associated with PAMM because individual sub-accounts could still be treated similar to commodity pool participation units because trades were being placed in quantities based on the overall equity in the master account and not in a quantity that would be permitted by the equity in each individual customer account. Therefore, the Interpretive Notice requires that CTAs allocate Forex orders for multiple accounts using regularly offered and tradable sized lots or contracts, and requires Members to adhere to the core principles and responsibilities applicable to the allocation of customer bunched orders.

NFA respectfully requests that the Commission review and approve the proposed adoption of the Interpretive Notice to NFA Compliance Rule 2-10 regarding the allocation of bunched retail Forex orders for multiple accounts.

Respectfully submitted,

Thomas W. Sexton
Senior Vice President and
General Counsel

*The proposed adoption of the Interpretive Notice entitled *NFA Compliance Rule 2-10: The Allocation of Bunched Retail Forex Orders for Multiple Accounts* becomes effective June 18, 2012.