



FUTURES INDUSTRY ASSOCIATION

INC.

2001 Pennsylvania Avenue N.W. • Suite 600 • Washington, DC 20006-1807 • (202) 466-5460
Fax: (202) 296-3184

02-4
③

OFFICE OF THE SECRETARIAL

COMMENT

April 26, 2002

Ms. Jean A. Webb
Secretary to the Commission
Commodity Futures Trading Commission
1155 21st Street NW
Washington DC 20581

RECEIVED
O.F.T.C.
RECEIVED O.F.T.C.
RECORDS SECTION
02 APR 27 AM 6 38

**Re: NFA Interpretive Notice Regarding Supervision of Automated
Order Routing Systems, 67 Fed.Reg. 14701, March 27, 2002**

Dear Ms. Webb:

The Futures Industry Association ("FIA") welcomes this opportunity to comment on the National Futures Association's ("NFA's") proposed Interpretive Notice Regarding Automated Order Routing Systems, which NFA submitted to the Commodity Futures Trading Commission ("Commission") for approval by letter dated March 1, 2002 ("Notice").¹ 67 Fed.Reg. 14701, March 27, 2002. FIA is pleased to support NFA's efforts to develop general standards for automated order routing systems. As the self-regulatory organization for the US futures industry, with particular responsibility for the protection of commodity futures market participants, NFA has an obvious role in providing such guidance to its members.

FIA also appreciates the difficult task that NFA faced in finding "a middle ground between one-size-fits-all requirements that mandate specific technology and guidelines that are so general as to be meaningless."² It was for this reason that we filed a substantial comment letter with NFA when the draft Notice was published on August 31, 2001.³ NFA responded to some, but not all, of these comments.

¹ FIA is a principal spokesman for the commodity futures and options industry. Our regular membership is comprised of approximately 50 of the largest futures commission merchants ("FCMs") in the United States, each of which is also a member of NFA. Among our associate members are representatives from virtually all other segments of the futures industry, both national and international. Reflecting the scope and diversity of our membership, FIA estimates that our members effect more than 90 percent of all customer transactions executed on US contract markets.

² Explanation of Proposed Amendments ("Explanation"), submitted to the Commission by letter dated March 1, 2002.

³ Letter from John M. Damgard, President, Futures Industry Association, to Kathryn Camp, Associate General Counsel, National Futures Association, November 15, 2001 ("November 15 Letter"). A copy of this letter is enclosed for the convenience of the Commission.

We are particularly pleased that NFA extensively revised its guidance with respect to authorization to confirm that responsibility for assuring that only authorized individuals have access to AORS using a customer's facilities and authentication devices rests with the customer. The FCM's responsibility is to provide the customer with a means of notifying the FCM that certain individuals are no longer authorized to trade or to request that the authentication devices be disabled and to inform the customer of the notification process.⁴ In a footnote, NFA also appears to have adopted FIA's recommendation that the notice should confirm that written supervisory procedures are not required when appropriate safeguards are built into the automated trading system itself.⁵ In addition, with respect to the paragraph relating to security administration, NFA accepted FIA's recommendation to amend the guidance to provide that the responsibility for assuring the security of an order routing system rests with the firm and not a single individual.⁶

NFA adopted these and other comments, noted below, made in our November 15 Letter, but chose not to accept others.⁷ We acknowledge that some of these latter comments may have appeared simply to request word changes that are technical in nature. Although subtle perhaps, we nonetheless believe the requested changes were, and remain, important, describing more accurately the current state of technology with respect to automated order routing systems and the supervisory capabilities of member firms with respect to such technology. After careful consideration, therefore, we determined to take this opportunity to reiterate them here.

Specific Comments

Security: Firewalls. In our November 15 Letter, we opposed the proposed requirement that a warning be generated if a firewall is breached. We reaffirm our position. Firewalls, of course, are designed to allow into a system only information that satisfies specific protocols. An unauthorized person can be said to "breach" a firewall only if that person is able to find a

⁴ In the draft release, the Notice provided that member firms should check periodically with each customer "to verify that the individuals authorized by the customer to access the AORS are still authorized to do so and to discover whether any passwords (or other form of authentication) should be disabled."

⁵ Notice, fn. 1.

⁶ The August 31 draft had indicated that NFA members should assign supervisory responsibility to "an appropriate supervisor." FIA had objected to this standard, asserting that it is the member firm's responsibility to determine the number of people who should be responsible for the security of the member's system. It is not necessary or appropriate to require that one individual be held responsible.

⁷ As a general comment not directly related to the substance of the Notice, FIA suggests that the Commission consider whether, in submitting rules to the Commission for approval, NFA and other SROs should be asked to prepare explanatory documents that more closely parallel in content the type documents that the Commission is required to prepare under the Administrative Procedure Act. We believe that, in appropriate circumstances, it would facilitate the Commission's review of particular rules and assist member firms in understanding more fully their underlying purpose, if the SRO described in some detail the significant comments received on proposed rules and the SRO's response to such comments.

weakness in the protocols to exploit. We have been advised that the vast majority of firewalls are not designed to analyze the system for such breaches. Of those that are so designed, few conduct such analyses very well. Consequently, we believe that it would be impossible for member firms to comply with this proposed requirement.⁸

Security: Periodic Testing. In the November 15 Letter, FIA objected to the requirement that member firms conduct "periodic testing of the security" of the order routing system using independent audit departments or qualified third parties. Internal audit departments do not necessarily have the expertise to conduct such tests. For example, if a member firm uses order routing systems developed by third parties, senior staff in the member firm's systems department may be the most qualified and in the best position to evaluate the third party developed software for security measures. Moreover, third parties with the necessary technical expertise to test these systems are few and are likely to be expensive.

NFA responded to FIA's comment by revising this paragraph to provide that such testing could be conducted by "other appropriate means." Although we appreciate this modification, it did not address FIA's essential recommendation that a member firm be required only to "review periodically" the security procedures for its system.

Since our November 15 Letter, we have talked with representatives of information technology departments who have explained in greater detail the procedures that such departments employ in connection with any trading system or other software. Their explanation supports our earlier recommendation that the system should be subject to periodic review, not testing. As described, these systems are tested at the time that they are initially designed and installed. However, once the system is operating, it is not common to conduct periodic tests to confirm that the system still operates as designed and is able to perform the same functions. Rather, information technology departments will periodically review the business purpose for which the system was designed in light of the entity's current business and the current state of technology for security systems. It will then determine whether to recommend that the systems be upgraded or otherwise modified.

Capacity Reviews. FIA did not comment on these paragraphs in its November 15 Letter. However, in preparation of this letter, several points have been raised, which we believe require comment. We agree that a member firm should evaluate the capacity of its AORS regularly. Nonetheless, the statement requiring firms to subject the system to periodic stress tests concerns us. First, as noted above, periodic tests, as opposed to periodic reviews of the business purpose of

⁸ In our November 15 Letter, we also objected to the apparent requirement that member firms adopt the specific security measures identified in the Notice. Although authentication methods, encryption and firewalls may describe the more obvious means of assuring security of a system that may be available currently, we noted that these procedures may not always be available nor should they be mandatory for all member firms regardless of their size, structure or type of business. Moreover, since technology is constantly evolving, member firms should not be locked into using encryption and firewalls, for example, if more appropriate and effective security procedures are developed or identified.

the system, in light of the entity's current business and the current state of technology, is not something that information technology departments generally conduct.

Second, the Notice does not acknowledge that a firm's ability to conduct stress tests or reviews of any kind generally is subject to the facilities provided for such purpose by the relevant exchanges. Certainly, live testing is not possible. We suggest, therefore, that this sentence be rewritten to provide:

The procedures should also provide that the system will be subjected to an initial stress test, if available. Such test may be conducted through simulation or other available means. Thereafter, the system should be subject to periodic reviews, using an independent internal audit department, a qualified outside party or other appropriate means.

FIA also requests additional guidance on a firm's proposed responsibility to provide adequate capacity "to meet estimated peak volume based on past experience, present demands and projected demands." We believe NFA should confirm that a firm could reasonably determine to meet volume beyond a particular level by employing one or more of the procedures described in "Disaster Recovery and Redundancies." That is, rather than seeking to assure that its system is reasonably designed to meet "estimated peak volume", a member firm could elect to employ instead facilities for accepting orders by telephone or reliance on third party brokers or clearing firms.⁹

Credit and Risk Management Controls: Pre-Execution and Post Execution Controls. In its November 15 Letter, FIA noted that it did not object to this standard, provided it is clear that the decision whether to impose pre-execution or post-execution controls remains with the member firm. Nonetheless, we also noted our understanding that the systems intended to permit a firm to impose pre-execution controls are not well developed. In particular, complex trading strategies involving options are not well suited for pre-execution control processes. Similarly, the requirement with respect to post-execution controls appears to assume that a member firm will always be able to monitor trading "promptly." This is not always possible, especially where the customer may execute a portion of its transactions through the telephone or through an executing broker. These trades are not taken into account by an automated order routing system, and often are not seen electronically on trade date.¹⁰

⁹ NFA should also clarify the standards by which a member firm is to estimate peak volume based on "projected demands."

¹⁰ NFA did not make any substantive revisions to these paragraphs in response to FIA's comments. These caveats to NFA's general guidance are important, and we continue to believe the Notice should be revised to acknowledge them.

Credit and Risk Management Controls: Direct Access Systems. In our November 15 Letter, we opposed, and continue to oppose, the proposed requirement that member firms use pre-execution controls whenever a customer is allowed to use a direct access system that does not allow a member to monitor trading promptly. We agree that a member firm should consider whether to impose such controls. However, that decision, which is a business decision, should rest with the member firm.

It is also important to note that certain exchange-provided terminals do not permit carrying firms to impose pre-execution controls. Moreover, exchanges are providing the API interfaces to order routing vendors that do not provide pre-execution control ability. These vendors often market their systems directly to the end-users. FIA recognizes that the Notice provides that a member is not responsible for a system chosen by the customer, including systems provided by exchanges. Nonetheless, within the same sentence, NFA states that the member "is nevertheless responsible for adopting procedures reasonably expected to address the trading, clearing, and other risks attendant to its customer relationship." NFA should first address this issue directly with the exchanges and not the member firms. Any exchange-sponsored systems should include these controls, which enhance the integrity of the entire system.

WebTrustSM/TM Self Assessment Questionnaire

Finally, FIA requests that NFA confirm the manner in which member firms are expected to use the WebTrustSM/TM Self Assessment Questionnaire, which is incorporated into NFA's Self-Examination Questionnaire. As the Commission no doubt is aware, a substantial portion of the WebTrust Questionnaire simply is inapplicable to the type of entities that comprise NFA's membership. Therefore, we do not believe that it is appropriate or NFA's intent that member firms should be required to complete the WebTrust Questionnaire in connection with the annual self-examination. Rather, it is our understanding that the purpose of the WebTrust Questionnaire is to provide general guidance to member firms as they develop written procedures governing automated order routing systems. Nonetheless, certain FIA member firms have asked that NFA clarify its position in this regard.

Conclusion

FIA appreciates the opportunity to comment on NFA Proposed Interpretive Notice. As noted above, FIA believes that the revisions recommended in this letter and in our November 15 Letter are more than technical in nature. They are meaningful and will clarify the supervisory responsibilities of member firms by reducing what we believe are apparent ambiguities in the Notice as submitted to the Commission. We would be pleased to work with NFA in making the necessary modifications to the Notice.

If the Commission has any questions concerning the comments in this letter, please contact Barbara Wierzynski, FIA's General Counsel, or me at 202.466.5460.

Sincerely,

Ms. Jean A. Webb
April 26, 2002
Page 6

John M. Damgard
President

cc: Honorable James E. Newsome, Chairman
Honorable Barbara Pedersen Holum
Honorable Thomas J. Erickson
Lawrence B. Patent, Division of Trading and Markets
Christopher W. Cummings, Division of Trading and Markets

Thomas W. Sexton III, National Futures Association