

## **COMMODITY FUTURES TRADING COMMISSION**

**17 CFR Parts 1, 3, 4, 140 and 155**

**RIN 3038-AB56**

### **Rules Relating to Intermediaries of Commodity Interest Transactions**

**AGENCY:** Commodity Futures Trading Commission.

**ACTION:** Proposed rulemaking.

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**SUMMARY:** Following the enactment of the Commodity Futures Modernization Act of 2000 (CFMA) and the resulting revisions to the Commodity Exchange Act (CEA or Act), the Commodity Futures Trading Commission (CFTC or Commission) is proposing rules relating to intermediation of commodity futures and commodity options (commodity interest) transactions. These proposed new rules and rule amendments would provide greater flexibility in several areas, and address, among other things, the definition of the term “principal,” certified financial reports, ethics training, disclosure, account opening procedures, trading standards, reporting requirements, and offsetting positions. The Commission would also make additional changes to allow a registrant to notify the Commission when a new natural person is added as a principal promptly after the change occurs.

The proposed rules are consistent with the mandate of the CFMA to streamline regulation of entities registered under the Act. Most of the proposed new rules and rule amendments were part of the Commission’s final rules relating to intermediaries that were adopted in December 2000, and subsequently withdrawn following the CFMA’s enactment in order to determine their consistency with the CFMA (December Release). Upon reviewing the proposed rules in light of the CFMA, as described in greater detail below, the Commission has determined that the rules

proposed herein are consistent with the CFMA. The Commission encourages interested persons to read the December Release and the proposals published in June 2000 for a discussion of the background and purpose of each of the rules and rule amendments that is not described in detail in this Federal Register release.

**DATES:** Comments must be received by [INSERT DATE 15 DAYS AFTER DATE OF PUBLICATION IN THE FEDERAL REGISTER].

**ADDRESSES:** Comments on the proposed rules should be sent to Jean A. Webb, Secretary, Commodity Futures Trading Commission, Three Lafayette Centre, 1155 21<sup>st</sup> Street, NW, Washington, DC 20581. Comments may be sent by facsimile transmission to (202) 418-5521, or by e-mail to [secretary@cftc.gov](mailto:secretary@cftc.gov). Reference should be made to “Proposed Rules Concerning Intermediaries.”

**FOR FURTHER INFORMATION CONTACT:** Lawrence B. Patent, Associate Chief Counsel, or Michael A. Piracci, Attorney-Advisor, Division of Trading and Markets, Commodity Futures Trading Commission, Three Lafayette Centre, 1155 21st Street, NW, Washington, DC 20581. Telephone: (202) 418-5450.

**SUPPLEMENTARY INFORMATION:**

**Table of Contents**

I. Background

II. Proposed Rules

A. Registration

1. Definition of the Term “Principal”
2. Application Procedures for IBs and FCMs
3. Special Procedures Available to Firms Subject to Securities or Banking Regulation

B. Fitness and Supervision

## C. Financial Requirements

1. Trading by Non-Institutional Customers on DTFs
2. Segregation of Funds
3. Investment of Customer Funds

## D. Risk Disclosure and Account Statements

## E. Trading Standards

## F. Recordkeeping

1. Customer Account Statements
2. Close-Out of Offsetting Positions

## III. Section 4(c) Findings

## IV. Cost-Benefit Analysis

## V. Related Matters

### A. Regulatory Flexibility Act

### B. Paperwork Reduction Act

## I. Background

Section 2 of the CFMA sets forth the purposes of the CFMA, which include streamlining and eliminating unnecessary regulation for the commodity futures exchanges and other entities regulated under the Act. Section 125 of the CFMA directs the Commission to complete a study of its rules, regulations and interpretations governing the conduct of persons registered under the Act by December 21, 2001. The proposed rules are designed to be an initial step in fulfilling the mandates of Section 2 and Section 125.

Most of the proposed new rules and rule amendments were part of the Commission's final rules relating to intermediaries that were adopted in December 2000, and subsequently withdrawn following the CFMA's enactment in order to determine their consistency with the

CFMA (December Release).<sup>1</sup> Upon reviewing the proposed rules in light of the CFMA, as described in greater detail below, the Commission has determined that the rules proposed herein are consistent with the CFMA. The Commission encourages interested persons to read the December Release and the proposals published in June 2000 for a discussion of the background and purpose of each of the rules and rule amendments that is not described in detail in this Federal Register release.

As further discussed below, certain rules have been modified to conform to specific provisions of the CFMA. Thus, for example, Section 111 of the CFMA permits a registered derivatives transaction execution facility (DTF) to allow by rule certain persons who are regulated by other federal financial regulatory agencies to act as intermediaries thereon in limited instances without first registering with the Commission. Accordingly, the Commission will not repropose the “passporting” registration procedure for certain otherwise regulated entities as previously contemplated.<sup>2</sup> The Commission may revisit this issue in the context of the study mandated by Section 125 of the CFMA, which requires a review of the Act and Commission rules thereunder pertaining to registrants.

The proposals discussed in this release are applicable generally to intermediaries transacting business on behalf of customers on designated contract markets and registered DTFs.

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<sup>1</sup> See Rules Relating to Intermediaries of Commodity Interest Transactions, 65 FR 39008 (June 22, 2000) (proposed rules); Rules Relating to Intermediaries of Commodity Interest Transactions, 65 FR 77993 (Dec. 13, 2000) (final rules); 65 FR 82272 (Dec. 28, 2000) (final rules; partial withdrawal).

<sup>2</sup> In addition, Section 252(b)(2) of the CFMA adds a new Section 4f(a)(2) to the Act to permit “notice” registration as a futures commission merchant (FCM) or an introducing broker (IB) by securities brokers or dealers that will limit their futures-related activities to security futures products. See also “Notice Registration as a Futures Commission Merchant or Introducing Broker for Certain Securities Brokers or Dealers,” 66 FR 27476 (May 17, 2001) (proposed rules); 66 FR 43080 (Aug. 17, 2001) (final rules).

To the extent that an existing rule is not addressed in this release, the Commission intends that the rule continues to apply to intermediaries transacting business on behalf of customers on designated contract markets and registered DTFs pending completion of the study mandated by Section 125, regardless of whether the contract market or DTF itself, or its operators, have been exempted from applicable provisions of the rule.<sup>3</sup> Thus, for example, under Rule 1.35, intermediaries would still be required to keep full and complete records, together with pertinent data and memoranda, of all transactions relating to their business of dealing in commodity interests,<sup>4</sup> notwithstanding the fact that the contract market or DTF on which the intermediaries transacted business would be exempt from the provisions of the rule that relate specifically to the exchange. When an intermediary transacts business on an exempt board of trade,<sup>5</sup> these transactions are generally subject only to the Commission's antifraud and antimanipulation authority to the extent applicable. Similarly, where a DTF permits trading only on a principal-to-principal basis, CFTC rules related only to intermediaries will not generally be applicable to such a market structure.<sup>6</sup>

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<sup>3</sup> See 66 FR at 14263, 14264 (stating in the proposed rulemaking to implement the new statutory framework that contract markets and DTFs, respectively, would be exempt from all Commission regulations applicable to a trading facility that are not reserved in the relevant Part). Unless otherwise noted, Commission rules referred to herein are found at 17 CFR Ch. I (2001).

<sup>4</sup> These required records include order tickets, a daily transaction record, a record of transactions by customer account, a financial ledger record and documentation concerning exchanges of futures for physicals.

<sup>5</sup> While the Act as amended provides that exempt commercial markets be restricted to transactions entered on a principal-to-principal basis (Section 2(h)(3)(A) of the Act), exempt boards of trade are not so restricted (Section 5d of the Act).

<sup>6</sup> A more complete description of the various new market structures can be found in "A New Regulatory Framework for Trading Facilities, Intermediaries and Clearing Organizations," 66 FR at 14264-66 (Mar. 9, 2001) (proposed rules).

Certain of the Commission's proposed rule amendments, such as those concerning ethics training and the definition of the term "principal," would affect all registered firms. The other new proposed rules and rule amendments would affect mainly FCMs and IBs, and are not applicable to commodity pool operators (CPOs) and commodity trading advisors (CTAs). The Commission intends to consider further rulemaking proposals at a subsequent date that will focus more directly upon Part 4 of the Commission's rules, which governs the operations and activities of CPOs and CTAs.

As examples of its ongoing reform efforts with regard to such persons, the Commission has adopted changes that simplify the regulatory framework for CPOs and CTAs dealing with certain highly accredited pool participants or clients, or "qualified eligible persons," and made this relief under CFTC Rule 4.7 available to more CPOs and CTAs by adding more persons to the definition of a "qualified eligible person."<sup>7</sup> The Commission has also adopted Rule 4.14(a)(9) to create an additional exemption from registration for CTAs that provide standardized advice by means of media such as newsletters, Internet web sites, and non-customized computer software.<sup>8</sup> Further, the Commission amended Part 30 of its rules by adding Rule 30.12 to allow CTAs with total assets under management exceeding \$50 million to place, directly with unregistered foreign futures and options brokers, orders for foreign futures or foreign options contracts for customers that do not otherwise qualify as "eligible swap participants."<sup>9</sup> In adopting Rule 30.12, the Commission incorporated industry requests to focus

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<sup>7</sup> See 65 FR 47848 (Aug. 4, 2000).

<sup>8</sup> See 65 FR 12938 (Mar. 10, 2000).

<sup>9</sup> See 65 FR 47275 (Aug. 2, 2000).

on the financial sophistication of the person managing the assets, rather than on the sophistication of the individual client advised by the CTA.<sup>10</sup> In addition, the CFTC adopted rule amendments to permit CPOs to deliver to prospective participants a summary “profile” document containing only key information about a pool prior to providing them with the pool’s complete disclosure document.<sup>11</sup>

## **II. The Proposed Rules**

### **A. Registration**

#### **1. Definition of the Term “Principal”**

Under Commission staff’s prior interpretation of the definition of the term “principal” in Rules 3.1(a)(1) and 4.10(e)(1),<sup>12</sup> all officers of a registrant were treated as principals and required to register as such.<sup>13</sup> In response to changes in management structures over the last 20 years and requests from registrants that certain employees, such as some vice presidents, not be considered principals because they do not exercise a controlling influence over the registrant or any of its activities subject to Commission regulation, the Commission is proposing to amend Rules 3.1(a)(1) and 4.10(e)(1) by defining as principals persons within a given organizational

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<sup>10</sup> Id. at 47277.

<sup>11</sup> 65 FR 58648 (Oct. 2, 2000).

<sup>12</sup> Rule 3.1(a) defines “principal” for purposes of the Commission’s Part 3 rules, which govern registration. Rule 4.10(e) defines “principal” for purposes of the Commission’s Part 4 rules, which apply to the activities of CPOs and CTAs.

<sup>13</sup> This interpretation was consistent with the language of the second proviso to Section 8a(2) of the Act, which states that a principal shall mean a general partner of a partnership, any officer, director or beneficial owner of at least ten percent of the voting shares of a corporation, “and any other person that the Commission by rule, regulation, or order determines has the power, directly or indirectly, through agreement or otherwise, to exercise a controlling influence over the activities of [firms] which are subject to regulation by the Commission.”

structure who hold specific offices.<sup>14</sup> A registrant would, therefore, no longer be required to treat every officer as a principal, but only those who meet the criteria of the rule as revised.<sup>15</sup> The proposed amendment to the definition of principal thus reduces the number of officers that will be considered principals, while ensuring that appropriate personnel, e.g., those that exercise, or are in a position to exercise a controlling influence over the registrant or any of its activities subject to Commission regulation, remain listed as such.

The principal definition would also include an individual who directly or indirectly, through agreement, holding company, nominee, trust or otherwise: (1) is the owner of ten percent or more of any class of a firm's securities; (2) is entitled to vote ten percent or more of any class of a firm's voting securities; (3) has the power to sell or direct the sale of ten percent or

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<sup>14</sup> Thus, the principal definition would include, if the entity is organized as a sole proprietorship, the proprietor; if a partnership, any general partner (including individuals and entities, such as corporations); if a corporation, any director, the president, chief executive officer, chief operating officer, chief financial officer, and any person in charge of a principal business unit, division or function subject to regulation by the Commission; and, if a limited liability company or limited liability partnership, any director, the president, chief executive officer, chief operating officer, chief financial officer, the manager, managing member or those members vested with management authority for the entity, and any person in charge of a principal business unit, division or function subject to regulation by the Commission. See proposed Rule 3.1(a)(1).

The reference in the proposed amendment to the "principal" definition to "any person in charge of a principal business unit subject to regulation by the Commission" would not include departments such as human resources or administration.

<sup>15</sup> As proposed, the "principal" definition will continue to include all directors of a corporate registrant. In addition, the definition will include the general provision that defines as a principal any person occupying a similar status as or performing similar functions to those persons specifically listed, having the power, directly or indirectly, through agreement or otherwise, to exercise a controlling influence over a firm's activities that are subject to regulation by the Commission. What constitutes "a controlling influence" will generally be left for determination on a case-by-case basis; however, such influence would be ascribed to, among others, those persons who have policymaking or managerial authority over the activities of an applicant or registrant that are subject to Commission regulation.

more of any class of a firm's voting securities; (4) has contributed ten percent or more of a firm's capital; or (5) is entitled to receive ten percent or more of a firm's profits. Further, the principal definition would include an entity that is the direct owner of ten percent or more of any class of a firm's securities or that has directly contributed ten percent or more of a firm's capital. These proposed amendments would permit the deletion of Rule 3.10(a)(2)(ii), which has proved somewhat unwieldy in practice.<sup>16</sup>

The Commission is also proposing conforming changes to Rules 4.24(f)(1)(v), 4.25(a)(8)(ii)(A) and 4.25(c)(2)(i)(B), applicable to CPOs, and 4.34(f)(1)(ii) and 4.35(a)(7)(ii)(A), applicable to CTAs, as incorporated by reference in amended Rule 4.10(e)(1). Accordingly, CPOs and CTAs would only be required to provide business backgrounds and proprietary trading results for those principals who participate in making trading or operational decisions, or supervise persons so engaged, and not for all officers.

Finally, in response to industry suggestions, the Commission is proposing to delete Rule 3.32, which specifies certain events or changes within a firm's management structure that require the firm to file a new registration form. In its place, a new paragraph (a)(2) would be added to Rule 3.31 to require the registrant to file a Form 8-R on behalf of each new natural person principal who was not listed on the registrant's Form 7-R promptly after the change occurs. Proposed Rule 3.31(a)(2) was drafted to closely parallel Rule 3.10(a)(2)(i),<sup>17</sup> and provides that, if the change that renders the application for registration deficient or inaccurate results from the addition of a new principal without a current Form 8-R on file with the National Futures

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<sup>16</sup> The proposed amendments would also result in the redesignation of Rule 3.10(a)(2)(i) as Rule 3.10(a)(2).

<sup>17</sup> As noted in the preceding footnote, this provision is proposed to be redesignated as Rule 3.10(a)(2).

Association (NFA), a Form 8-R for that principal must accompany the Form 3-R amending the registrant's application for registration.<sup>18</sup>

## 2. Application Procedures for IBs and FCMs

The Commission is proposing that applicants for registration as IBs who raise their own capital to satisfy minimum financial requirements would be permitted to file an unaudited financial report indicating satisfaction of the minimum requirements, rather than be required to provide certified financial statements with their registration application.<sup>19</sup> A firm taking advantage of the new procedure would be subject to an on-site review within six months of registration by the firm's DSRO or, at the DSRO's discretion, a conference between appropriate staff of the firm and the DSRO at the DSRO's offices.<sup>20</sup> This alternative procedure is modeled on similar procedures in the securities industry.<sup>21</sup>

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<sup>18</sup> An additional conforming amendment is proposed to Rule 3.21(c) that would reflect the deletion of Rule 3.32, and the addition of new paragraph (a)(2) to Rule 3.31.

<sup>19</sup> See Proposed Rule 1.10 (a)(2)(ii)(A)(3). However, those IB applicants who do not raise their own capital would continue to be required to file a guarantee agreement entered into with an FCM with their registration application. IBs and FCMs should refer to Commission Rules 1.10(j) and 1.57(a)(1) concerning the procedures applicable to guarantee agreements. See also First American Discount Corp. v. CFTC, 222 F.3d 1008 (D.C. Cir. Aug. 18, 2000).

Filing of financial statements or guarantee agreements would be unnecessary for any FCM or IB registered in accordance with Proposed Rule 3.10(a)(3), which applies to those securities brokers or dealers registering as FCMs or IBs because their only futures-related activities involve security futures products. See 66 FR 27476.

<sup>20</sup> Although the proposed rule would not require IBs to file a certified financial statement with their application for registration, this does not preclude any SRO from imposing this requirement before accepting an IB for membership.

<sup>21</sup> Certain technical amendments are also proposed to be made to paragraph (j)(8), which addresses guaranteed IBs' compliance with the financial reporting requirements in the event that their guarantee agreement has been terminated. Such IBs will be deemed to have satisfied the

With respect to the six-month review that must be conducted should an IB choose not to file a certified financial statement with its registration application, the Commission believes that the six-month time period for the review of IBs should begin from the date the applicant is registered. The Commission has held consistently that once a registrant becomes registered in a certain capacity, the registrant is immediately assumed to be engaging in the activities permitted by such registration.<sup>22</sup> However, the Commission notes that the DSRO would be able to conduct the review telephonically where the DSRO does not have reason to question the IB's capital. In addition, an applicant that does not wish to be subject to the six-month review could continue to follow the existing rules and file a certified financial statement with its application.

The Commission notes that the December Release contained a similar provision for FCM applicants. NFA commented that “[t]here is a significant difference in the role of FCMs and IBs in terms of safety of customer funds. The one-time filing requirement for FCMs is not unduly burdensome, especially in light of the potential exposure if the initial financial statement is incorrect.”<sup>23</sup> Upon further consideration in light of the comment filed by NFA opposing the elimination of the certified financial report for an FCM applicant, the Commission has determined not to repropose the rule change for FCM applicants.

### 3. Special Procedures Available to Firms Subject to Securities or Banking Regulation

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Commission's minimum financial requirements if they enter into another guarantee agreement or file a certified 1-FR-IB statement.

<sup>22</sup> See, e.g., In re Premex, [1982-1984 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 21,992 (Feb. 1, 1984), aff'd in relevant part, rev'd in part, 785 F.2d 1403 (9<sup>th</sup> Cir. 1986).

<sup>23</sup> NFA Comment Letter at 4 (Aug. 7, 2000), which can be found on the Commission's website at <http://www.cftc.gov/files/foia/comment00/foicf0022c024.pdf>

The December Release contained a “passporting” registration process for certain otherwise federally regulated FCMs or IBs who conduct business on futures exchanges solely for institutional customers.<sup>24</sup> The CFMA includes a passporting provision that is broader than the CFTC’s proposal in certain respects and narrower in others. The CFMA provision allows entities subject to regulation by an appropriate financial regulator to act as intermediaries on a DTF subject to the DTF’s election, provided that the entity meets certain conditions. Specifically, Section 111(e) of the CFMA authorizes a DTF to allow by rule a broker-dealer, depository institution, or institution of the Farm Credit System to act as an intermediary in transactions executed on the facility for any customer of the broker-dealer, depository institution or Farm Credit institution, provided that the firm is in good standing with its appropriate regulator. These passporting intermediaries would not be required to register with the Commission as an FCM or IB (or even to file a notice registration) or to become a member of a registered futures association, unless they carry or hold customer accounts or funds for transactions on the DTF for more than one business day.<sup>25</sup> In light of the CFMA provisions, the Commission will not be separately reproposing its earlier passporting proposal, or the related amendments to Rules 1.17(a)(2) or 1.52(m).<sup>26</sup> As noted above, however, the Commission

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<sup>24</sup> The term “institutional customer” is defined in proposed Rule 1.3(g) as an “eligible contract participant” within the meaning of section 1a(12) of the Act as amended, and generally refers to a non-retail customer.

<sup>25</sup> These firms and their salespersons would remain subject to antifraud provisions of the Act and rules thereunder, however.

<sup>26</sup> In the December Release, the Commission would have extended its passporting provision to allow broker-dealers and firms regulated by appropriate banking regulators to conduct transactions for institutional customers on designated contract markets and recognized futures exchanges in addition to DTFs. In light of the provisions contained in the CFMA, however, a broker-dealer, depository institution or Farm Credit institution seeking to act as an intermediary on a designated contract market will be required to register as an FCM or IB and become a

recently adopted rules that would permit securities brokers or dealers who limit their futures-related activities to security futures products to register as FCMs or IBs upon the submission of notice to the Commission.<sup>27</sup>

The Commission is separately considering updating and making more flexible its minimum net capital requirements for FCMs by adopting risk-based net capital requirements.

B. Fitness and Supervision

An essential component of maintaining fitness is continuing education concerning obligations under the Act and rules thereunder. In order to provide flexibility and ease compliance for all registrants, the Commission is proposing to delete Rule 3.34 and instead to implement Congressional intent regarding ethics training through a Statement of Acceptable Practices. Rule 3.34 currently specifies frequency and duration of ethics training, the suggested curriculum, qualifications of instructors, and the necessary proof of attendance at such classes. In proposing to replace the rule with a Statement of Acceptable Practices that would leave the format, frequency, and providers of ethics training up to the registrants themselves, the Commission believes that greater flexibility regarding ethics training and proficiency testing

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member of a registered futures association, even if the firm carries or holds accounts or funds for less than one business day.

Section 5a of the Act as amended further directs the Commission, in coordination with the SEC, the Secretary of the Treasury, and Federal banking regulatory agencies, to adopt rules and take any other appropriate action to facilitate the implementation of the passporting procedure by these otherwise federally regulated entities.

<sup>27</sup> See note 2 supra; see also "Exemption for Certain Brokers or Dealers from Provisions of the Commodity Exchange Act and CFTC Regulations," 66 FR 43083 (Aug. 17, 2001) (adopting new rule to govern the granting of orders exempting notice-registered broker-dealers from provisions of the Act and Commission regulations where the Commission determines that the exemption is necessary or appropriate in the public interest and consistent with the protection of investors).

could be afforded to registrants than is now permitted under Rule 3.34. For registrants seeking guidance as to the maintenance of proper ethics training procedures, the Statement of Acceptable Practices would serve as a “safe harbor.”<sup>28</sup>

Although the Commission notes the possibility that eliminating Rule 3.34 may lead firms to place an inadequate priority on ethics training, the Commission does not believe that the replacement of the rule with a Statement of Acceptable Practices would diminish a registrant’s obligations to remain fit and to adequately supervise the handling of customer accounts. Instead, the Commission hopes that the Statement of Acceptable Practices, which would allow registrants to adopt ethics training programs that are better tailored to their individual needs, will help to imbue firms with a culture of ethics that is ongoing rather than episodic. The Commission believes that the essence of the ethics training or continuing education requirement is to remain current as to the legal requirements applicable to a person’s role in the futures industry, which a registrant ignores at his or her peril.

The Commission is also proposing to publish its recent “guidance letters” issued to NFA concerning the treatment of SRO disciplinary actions in assessing the fitness of floor brokers (FBs) and floor traders (FTs). The guidance letters were issued to provide greater clarity in interpreting the “other good cause” ground for statutory disqualification from registration under Section 8a(3)(M) of the Act. These letters would be added to the end of Appendix A to Part 3 as they relate to the issue of “other good cause,” which is discussed at the end of Appendix A.

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<sup>28</sup> For instance, under the Statement of Acceptable Practices, registrants may engage in ethics training programs sponsored by the registrants themselves, their DSROs, trade associations or others. The format of such training, whether by personal or recorded instruction, or by circulation of written materials such as legal cases, interpretative letters or advisories, would also be left to the discretion of registrants and DSROs. It would also be permissible to require training on whatever periodic basis the registrants and DSROs deem appropriate. Thus, the Commission would not specify any particular programs or procedures that must be followed.

## C. Financial Requirements

### 1. Trading by Non-Institutional Customers on DTFs

Although access to DTFs is generally limited to institutional customers,<sup>29</sup> under certain conditions a DTF may permit non-institutional customers to enter into transactions thereon. To address the higher degree of risk associated with the lower regulatory protections offered to DTF participants, such non-institutional customer business may be transacted through a registered FCM that (1) is a clearing member of a derivatives clearing organization, and (2) has a minimum net capital of at least \$20 million.<sup>30</sup> Such an FCM is considered to be more capable of properly handling these transactions and the associated risk. In order to provide guidance to non-institutional customers trading through a highly-capitalized FCM, NFA will issue a Statement of Acceptable Practices regarding additional disclosures to be made to such customers trading on DTFs and on related issues involving price dissemination.

In the December Release, the Commission had determined to add a new Rule 4.32 that would also permit non-institutional customers to trade on a DTF through certain registered CTAs. The Commission is again proposing to adopt this rule to permit registered CTAs to enter trades on or subject to the rules of a DTF on behalf of a non-institutional customer, provided that the CTA: (1) directs the client's commodity interest account;<sup>31</sup> (2) directs accounts containing total assets of not less than \$25 million at the time the trade is entered; and (3) discloses to the

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<sup>29</sup> See new Part 37 of the Commission rules, 66 FR 42256 at 42271 (Aug. 10, 2001).

<sup>30</sup> Section 5a of the Act, 7 U.S.C. 7a, as amended by Pub. L. No. 106-554, 114 Stat. 2763.

<sup>31</sup> The term "direct" as defined in Rule 4.10(f), refers to, in the context of trading commodity interest accounts, "agreements whereby a person is authorized to cause transactions to be effected for a client's commodity interest account without the client's specific authorization."

client that it may enter trades on a DTF on the client's behalf. Paragraph (b) of Rule 4.32 further requires that the client's commodity interest account be carried by a registered FCM. However, an FCM who receives orders on behalf of a non-institutional customer from a CTA acting in accordance with Rule 4.32 need not maintain \$20 million in minimum adjusted net capital. See Rule 1.17(a)(1)(ii)(B).

As with a highly-capitalized FCM, a CTA meeting this asset test, in its capacity as a professional asset manager, would have the appropriate financial sophistication to handle the risk associated with trading for non-institutional customers on a DTF.<sup>32</sup> Additionally, focusing on the financial sophistication of the person managing the assets, rather than on the sophistication of the individual client advised by the CTA, is consistent with the approach taken by the Commission in adopting Rule 30.12.<sup>33</sup>

## 2. Segregation of Funds

The June 2000 Release raised two sets of questions seeking comments about whether, and under what circumstances, the Commission should permit (1) customers to opt out of segregation, and (2) FCMs to maintain, in the same customer segregated account, various instruments, such as over-the-counter (OTC) derivatives, equity securities, and other cash market positions, as well as the funds used for the purpose of securing or margining such products and positions.<sup>34</sup>

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<sup>32</sup> See Section 1a(12)(C) of the Act.

<sup>33</sup> See 65 FR at 47277.

<sup>34</sup> 65 FR at 39014.

With respect to the opt-out issue, most parties commenting on the issue urged the Commission to consider thoroughly the potential implications with respect to the bankruptcy rules, e.g., priority of distribution, before proceeding on the issue. Consequently, in the Adopting Release the Commission determined to continue to study the issue and defer action in this area.<sup>35</sup> Under Section 5a(f) of the Act, as amended by the CFMA, however, the Commission was required to adopt rules within 180 days after the date of enactment of the CFMA to permit a registered DTF to authorize an FCM to offer its customers that are eligible contract participants the right not to have their funds that are carried by the FCM for purposes of trading on the registered DTF, separately accounted for and segregated. Accordingly, on April 19, 2001, the Commission adopted new rules that, effective June 19, 2001, allow FCMs to offer eligible contract participants to opt out of segregation.<sup>36</sup> The Commission also amended existing rules concerning, among other things, the bankruptcy treatment of a customer that opts out of segregation.

### 3. Investment of Customer Funds

The Commission did not withdraw its final rules and rule amendments concerning the investment of customer funds, and those rules and rule amendments became effective on December 28, 2000. To facilitate the implementation of Rule 1.25 and its related amendments, new paragraph (a)(7) to Rule 140.91 is proposed to be added to delegate to the Director of the Division of Trading and Markets any functions reserved to the Commission in Rule 1.25 regarding permitted investments for customer funds. The Commission also wishes to note that it has determined not to rescind Division of Trading and Markets Financial and Segregation

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<sup>35</sup> See 65 FR at 78001.

<sup>36</sup> 66 FR 20740 (April 25, 2001).

Interpretation No. 9 (Interp. 9).<sup>37</sup> The Commission had previously indicated that it would do so in light of the fact that amendments to Rule 1.25 would now permit investment of customer funds in money market mutual funds (MMMFs).<sup>38</sup> Because Interp. 9 addresses the use of money market deposit accounts rather than MMMFs, however, the Commission has decided not to rescind Interp. 9.

D. Risk Disclosure and Account Statements

The disclosure of risks by intermediaries is an important customer protection. Over the years, however, certain persons have suggested that customers would be better protected by receiving risk disclosures more attuned to their relative level of sophistication and to the particular instruments they trade. Other commenters have suggested that disclosure obligations could be simplified and streamlined.

In keeping with these observations, the Commission proposes that non-institutional customers continue to receive the risk disclosures regarding futures and options trading that are currently required. Thus, intermediaries will continue to be required to obtain prior acknowledgement of their customers' receipt of the basic risk disclosure statements relating to futures and options in accordance with Rules 1.55 and 33.7. For institutional customers, as provided in proposed Rule 1.55(f), there would continue to be no general disclosure requirements.<sup>39</sup> The Commission also may consider issuing a Statement of Acceptable Practices

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<sup>37</sup> Comm. Fut. L. Rep. (CCH) ¶ 7119 (Nov. 23, 1983).

<sup>38</sup> See 65 FR at 78001 n.53.

<sup>39</sup> In contrast to the December Release, which did not restrict the type of governmental entities that would be considered to be institutional customers, the Act as amended imposes certain limitations on the governmental entities that will be considered to be eligible contract participants. Compare 65 FR at 78035 with section 1a(12)(A)(vii) of the Act as amended.

on disclosure to institutional customers, with industry input, at a later date. As noted above, the Commission also anticipates that NFA will develop appropriate disclosure for qualifying FCMs to provide to retail customers permitted to trade on DTFs.

The Commission recognizes that there are certain areas of the account opening process that may be streamlined. Accordingly, in proposed amendments to Rules 1.55(d)(1) and (2), the Commission would permit certain required disclosures, such as those concerning consent to (1) allow electronic transmission of statements under proposed new Rule 1.33(g),<sup>40</sup> or (2) transfer funds out of segregated accounts to another account (such as a money market account), to be included in a customer agreement and acknowledged through a “single signature,” rather than the multiple signatures that are currently required.<sup>41</sup> The single signature could be made electronically as provided for in recently-adopted Rules 1.3(tt) and 1.4.<sup>42</sup>

#### E. Trading Standards

The Commission is proposing that Rules 155.1, 155.3 and 155.4, which collectively require FCMs and IBs to establish and to maintain supervisory procedures to assure that neither they nor any affiliated persons use their knowledge of customer orders to the customer’s disadvantage, would continue to apply to intermediation of trades on contract markets, with certain conforming changes to reflect the recent statutory changes to the Act. These

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<sup>40</sup> See infra.

<sup>41</sup> Contemporaneously with opening an account, an FCM may obtain the acknowledgment of receipt and understanding of the risk disclosure statement, along with margin funds and any other required account opening documents, from the customer. However, the FCM remains responsible for ensuring that the risk disclosure document is furnished to the customer in such a way that the customer can review and understand the document before committing funds to the FCM.

<sup>42</sup> 65 FR 12466 (Mar. 9, 2000).

requirements would be extended to trading by non-institutional customers on DTFs under proposed Rule 155.6(a). These rules over the years have helped the Commission deter such practices as “front-running,” “trading ahead,” “bucketing,” and improper disclosure of customer orders. However, for intermediation of trades by institutional customers at DTFs, the Commission is proposing a new Rule 155.6(b), which sets forth a general standard of practice in this area. The Commission believes that this overall approach with respect to trading standards strikes a reasonable balance in preserving rules that have worked successfully over the years in curbing abusive trading practices, while relaxing certain of the specific provisions of the existing rules in connection with the trading on DTFs by more sophisticated customers.

Although proposed new Rule 155.6 is intended to proscribe the same trade practice abuses as Rules 155.1, 155.3 and 155.4 the Commission encourages specific suggestions regarding how these rules might be streamlined.<sup>43</sup> The Commission also will consider the development of a Statement of Acceptable Practices to be issued at a later date, with the consultation of DTFs, regarding appropriate procedures that should be employed in order to ensure compliance with the general standard.<sup>44</sup>

F. Recordkeeping

1. Customer Account Statements

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<sup>43</sup> The Commission recently proposed to prohibit dual trading in security futures products on designated contract markets and registered DTFs, as required by Section 251(c) of the CFMA, which amended Section 4j of the Act. See 66 FR 36218 (July 11, 2001).

<sup>44</sup> Because the DTF is a new institution, and it is not known how such an institution would choose to operate (e.g., a DTF may choose to sponsor trading in a traditional open-outcry pit trading system, in a purely automated, electronic trading format, or in a combination of the two formats), the Commission is not at this time issuing a Statement of Acceptable Practices in this area.

In keeping with changes in technology and commercial practices, the Commission is proposing to codify its previous Advisory relating to the electronic transmission of account statements in a new Rule 1.33(g).<sup>45</sup> Thus, an FCM would be permitted, with customer consent, to deliver required confirmation, purchase-and-sale, and monthly account statements electronically in lieu of mailing a paper copy. FCMs would need only to retain the daily confirmation statement as of the end of the trading session, provided that it reflects all trades made during that session. Before transmitting any statement electronically to a customer, however, the FCM would be required to make certain disclosures regarding the practice, including: (1) the electronic medium or source through which statements would be delivered, (2) the duration, whether indefinite or not, of the period during which consent would be effective, (3) any charges for such service, (4) the information that would be delivered electronically, and (5) a statement that consent to electronic delivery may be revoked at any time. For non-institutional customers, the FCM would be required to obtain the customer's signed consent acknowledging the disclosures, prior to the transmission of any statement by means of electronic media. The acknowledgement could be made through a single signature in accordance with Rule 1.55 as discussed above. Institutional customers would not need to provide written consent, and the Commission recommends that FCMs confirm procedures relating to electronic transmission of statements to institutional customers as described in the above-referenced Advisory. Any statement required to be furnished to a person other than a customer in accordance with paragraph (d) of Rule 1.33 would also be permitted to be furnished by electronic media.

## 2. Close-Out of Offsetting Positions

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<sup>45</sup> 65 FR at 39017; see also 62 FR 31507 (June 10, 1997).

The Commission also proposes to revise Rule 1.46 to allow customers or account controllers to instruct the FCM (in writing or orally) if they wish to deviate from the current default rule that the FCM close out offsetting positions on a first-in, first-out basis, looking across all accounts it carries for the same customer.<sup>46</sup> CPOs and CTAs would be required to disclose, under proposed amendments to Rules 4.24(h)(2) and 4.34(h), respectively, if they instruct an FCM to deviate from the default rule for closing out offsetting positions.<sup>47</sup>

In order to implement this revision of Rule 1.46, the Commission proposes to amend the rule by inserting, after the words “omnibus accounts” in paragraph (a), the phrase “or where the customer or account controller has instructed otherwise.” Rule 1.46 also would be amended by revising paragraph (e) to correspond to proposed new Rule 1.33(g) (the substance of the current paragraph (e) of Rule 1.46 would be deleted because it relates back to paragraph (d)(6), which is being removed and reserved) to read: “The statements required by paragraph (a) of this section may be furnished to the customer or the person described in § 1.33(d) by means of electronic transmission, in accordance with § 1.33(g).”

### **III. Section 4(c) Findings**

Certain of the rules and rule amendments discussed herein are being proposed under Section 4(c) of the Act, which grants the Commission broad exemptive authority. Section 4(c) of the Act provides that, in order to promote responsible economic or financial innovation and

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<sup>46</sup> An FCM must take into consideration positions in separate accounts of the same customer that it is carrying in applying Rule 1.46. See 57 FR 55082, 55083 n.2 (Nov. 24, 1992), citing U.S. Department of Agriculture, Commodity Exchange Authority Administrative Determination No. 134 (May 25, 1948).

<sup>47</sup> Generally, responsibility for transmitting instructions regarding offset would lie with the registrant directing trading. Thus, where a pool’s trading is directed by a CTA, it would be the CTA who would be responsible for transmitting offset instructions, not the CPO.

fair competition, the Commission may, by rule, regulation or order, exempt any class of agreements, contracts or transactions, including any person or class of persons offering, entering into, rendering advice or rendering other services with respect to the agreement, contract, or transaction, from any of the provisions of the Act (except certain provisions governing a group or index of securities and security futures products). As relevant here, when granting an exemption pursuant to Section 4(c), the Commission must find that the exemption would be consistent with the public interest.

As explained above, the proposed rules and rule amendments would provide greater flexibility for intermediaries and their customers in several areas. Specifically, the Commission is proposing rule amendments concerning the definition of the term “principal” that are narrower than the language of the second proviso of Section 8a(2) of the Act. These amendments recognize the evolution of management structures by reducing the number of officers that will be considered principals, while ensuring that appropriate personnel that perform significant roles within the firm remain listed as such. The Commission believes that, in light of the conditions and safeguards provided for under the rules and rule amendments, the exemptive relief will have no adverse effect on any of the regulatory or self-regulatory responsibilities imposed by the Act. Moreover, the Commission believes that the additional flexibility for intermediaries and their customers provided for by the rules and rule amendments proposed herein would be consistent with the public interest. The Commission invites public comment on this finding.

#### **IV. Cost-Benefit Analysis**

Section 15 of the Act, as amended by Section 119 of the CFMA, requires the Commission to consider the costs and benefits of its action before issuing a new regulation under the Act. By its terms, Section 15 as amended does not require the Commission to quantify the

costs and benefits of a new regulation or to determine whether the benefits of the proposed regulation outweigh its costs. Rather, Section 15 simply requires the Commission to “consider the costs and benefits” of its action.

The amended Section 15 further specifies that costs and benefits shall be evaluated in light of five broad areas of market and public concern: protection of market participants and the public; efficiency, competitiveness, and financial integrity of futures markets; price discovery; sound risk management practices; and other public interest considerations. Accordingly, the Commission could in its discretion give greater weight to any one of the five enumerated areas and could in its discretion determine that, notwithstanding its costs, a particular rule was necessary or appropriate to protect the public interest or to effectuate any of the provisions or to accomplish any of the purposes of the Act.

The proposed rulemaking constitutes a package of related rule provisions affecting market intermediaries. The proposed rules and rule amendments are intended to provide greater flexibility for intermediaries and their customers in their methods of doing business. The Commission is considering the costs and benefits of these rules in light of the specific provisions of Section 15 of the Act:

1. Protection of market participants and the public. In general, the proposed rules would be expected to cost little in terms of diminishing the protection of market participants and the public.
2. Efficiency and competition. The proposed rules are expected to benefit competition and market efficiency broadly by providing increased flexibility for intermediaries. For instance, the Commission is proposing new rule amendments concerning the definition of the term “principal” that recognize the evolution of management structures by reducing the number

of officers that will be considered principals, while ensuring that personnel that exercise or are in a position to exercise a controlling influence over the activities of the registrant will remain listed as such. In addition, FCMs will be permitted to obtain several consents from consumers with a single signature. The rules do not impose a cost on market efficiency or competition.

3. Financial integrity of futures markets and price discovery. The proposed rules should have no effect, from the standpoint of imposing costs or creating benefits, on the financial integrity or price discovery function of the futures and options markets or on the risk management practices of FCMs, CTAs, CPOs or IBs.

4. Sound risk management practices. The Commission has previously adopted amendments to its rules regarding the investment of customer funds that were originally part of the December Release. These amendments expanded the list of permissible investments in which FCMs and clearing organizations are permitted to invest cash segregated for the benefit of commodity customers, thereby enhancing the yield available to FCMs, clearing organizations and their customers, and contained specific risk-limiting features intended to minimize credit risk, market risk, and liquidity risk.

5. Other public interest considerations. The Commission's rules implementing the new regulatory structure would open up new markets for the benefit of market participants and the public, thus making available more customized products for risk management purposes. The proposed new rules and rule amendments contained herein would establish appropriate safeguards for those customers seeking to trade on the new DTF and security futures product markets.

After considering these factors, the Commission has determined to propose the revisions to its rules discussed above. The Commission invites public comment on its application of the

new cost-benefit provision. Commenters also are invited to submit any data that they may have quantifying the costs and benefits of the proposed rules with their comment letters.

## **V. Related Matters**

### **A. Regulatory Flexibility Act**

The Regulatory Flexibility Act (RFA), 5 U.S.C. 601 et seq. (1994 & Supp. II 1996), requires federal agencies, in proposing rules, to consider the impact of those rules on small businesses. The rules proposed herein would affect FCMs, IBs, CPOs, CTAs, FBs, FTs, leverage transaction merchants (LTMs) and agricultural trade option merchants (ATOMs), as well as principals thereof. The Commission has previously established certain definitions of “small entities” to be used by the Commission in evaluating the impact of its rules on small entities in accordance with the RFA.<sup>48</sup> The Commission has previously determined that registered FCMs, CPOs, LTMs and ATOMs are not small entities for the purpose of the RFA.<sup>49</sup> With respect to IBs, CTAs, FBs and FTs, the Commission has stated that it is appropriate to evaluate within the context of a particular rule proposal whether some or all of the affected entities should be considered small entities and, if so, to analyze the economic impact on them of any rule. In this regard, the rules being proposed herein would not require any registrant to change its current method of doing business. For many registrants, the proposed revisions should decrease the number of persons within the registrant’s organization who would be considered principals under the CFTC’s rules. Further, the proposed revisions should reduce, rather than increase, the regulatory requirements that apply to registrants and applicants for

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<sup>48</sup> 47 FR 18618-21 (Apr. 30, 1982).

<sup>49</sup> Id. at 18619-20 (discussing FCMs and CPOs); 54 FR 19556, 19557 (May 8, 1989) (discussing LTMs); and 63 FR 18821, 18830 (Apr. 16, 1998) (discussing ATOMs).

registration, regardless of size. Accordingly, pursuant to 5 U.S.C. 605(b), the Acting Chairman, on behalf of the Commission, certifies that the proposed amendments will not have a significant economic impact on a substantial number of small entities. The Commission invites the public to comment on this finding.

B. Paperwork Reduction Act

This proposed rulemaking contains information collection requirements. As required by the Paperwork Reduction Act of 1995, 44 U.S.C. § 3507(d), the Commission has submitted a copy of these proposed amendments to its rules to the Office of Management and Budget (OMB) for its review.

**Collection of Information**

Rules Relating to the Operations and Activities of Commodity Pool Operators and Commodity Trading Advisors and to Monthly Reporting by Futures Commission Merchants, OMB Control Number 3038-0005.

Rules Pertaining to Contract Markets and Their Members, OMB Control Number 3038-0022.

Regulations and Forms Pertaining to the Financial Integrity of the Marketplace, OMB Control Number 3038-0024.

The proposed amendments would not affect the paperwork burdens associated with the above collections of information, which have previously been approved by OMB in connection with the Commission's previous submission of the proposed rules.

Rules, Regulations and Forms for Domestic and Foreign Futures and Options Relating to Registration with the Commission, OMB Control Number 3038-0023.

The proposed rules will reduce the collection of information burden previously approved by OMB by 2 hours because of the elimination of Rule 3.32:

<u>Estimated number of respondents (after proposed amendment):</u>	0
<u>Annual responses by each respondent:</u>	0
<u>Estimated average hours per response:</u>	0
<u>Annual reporting burden:</u>	0 hours.

The annual reporting burden of 7,337 hours represents a reduction of 2 hours as a result of the proposed new rules.

Copies of the information collection submission to OMB are available from the CFTC Clearance Officer, 1155 21st Street, NW, Washington, DC 20581, (202) 418-5160.

Persons wishing to comment on the information collection requirements that would be required by these proposed rules should contact the Office of Information and Regulatory Affairs, Office of Management and Budget, Room 10235, New Executive Office Building, Washington, DC 20503, Attn: Desk Officer for the Commodity Futures Trading Commission.

The Commission considers comments by the public on this proposed collection of information in --

- Evaluating whether the proposed collection of information is necessary for the proper performance of the functions of the Commission, including whether the information will have a practical use;
- Evaluating the accuracy of the Commission's estimate of the burden of the proposed collection of information including the validity of the methodology and assumptions used;
- Enhancing the quality, utility, and clarity of the information to be collected; and

- Minimizing the burden of the collection of the information on those who are to respond, including through the use of appropriate automated, electronic, mechanical or other technological collection techniques or other forms of information technology, e.g., permitting electronic submissions of responses.

OMB is required to make a decision concerning the collection of information contained in these proposed regulations between 30 and 60 days after publication of this document in the Federal Register. Therefore, a comment to OMB is best assured of having its full effect if OMB receives it within 30 days of publication. This does not affect the deadline for the public to comment to the Commission on the proposed regulations.

Copies of the information collection submission to OMB are available from the CFTC Clearance Officer, 1155 21<sup>st</sup> Street, NW, Washington, DC 20581 (202) 418-5160.

### **Lists of Subjects**

#### 17 CFR Part 1

Brokers, Commodity futures, Consumer protection, Reporting and recordkeeping requirements.

#### 17 CFR Part 3

Administrative practice and procedure, Brokers, Commodity futures, Principals, Registration, Reporting and recordkeeping requirements.

#### 17 CFR Part 4

Advertising, Commodity futures, Commodity pool operators, Commodity trading advisors, Consumer protection, Disclosure, Principals, Reporting and recordkeeping requirements.

#### 17 CFR Part 140

Authority delegations (Government agencies), Conflict of interests, Organization and functions (Government agencies).

17 CFR Part 155

Brokers, Commodity futures, Reporting and recordkeeping requirements.

For the reasons discussed in the preamble, the Commission hereby proposes to amend 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 is amended to read as follows:

**Authority:** 7 U.S.C. 1a, 2, 5, 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, as amended by the Commodity Futures Modernization Act of 2001, Appendix E of Pub. L. No. 106-554, 114 Stat. 2763 (2000).

2. Section 1.3 is amended by adding new paragraph (g) to read as follows:

**§ 1.3 Definitions.**

\* \* \* \* \*

(g) Institutional customer. This term has the same meaning as “eligible contract participant” as defined in section 1a(12) of the Act.

\* \* \* \* \*

3. Section 1.10 is amended as follows:

- a. Redesignating paragraph (a)(2)(i) as paragraph (a)(2)(i)(A);
- b. Redesignating paragraph (a)(2)(i)(A) as paragraph (a)(2)(i)(A)(1);
- c. Redesignating paragraph (a)(2)(i)(B) as paragraph (a)(2)(i)(A)(2), and revising it;
- d. Designating the undesignated paragraph following paragraph (a)(2)(i)(B) as paragraph

(a)(2)(i)(B) and revising it;

e. Redesignating paragraph (a)(2)(ii) as paragraph (a)(2)(ii)(A);

f. Redesignating paragraph (a)(2)(ii)(A) as paragraph (a)(2)(ii)(A)(1) and revising it;

g. Redesignating paragraph (a)(2)(ii)(B) as paragraph (a)(2)(ii)(A)(2) and revising it;

h. Redesignating paragraph (a)(2)(ii)(C) as paragraph (a)(2)(ii)(A)(4);

i. Adding a new paragraph (a)(2)(ii)(A)(3);

j. Designating the undesignated paragraph following paragraph (a)(2)(ii)(C) as paragraph

(a)(2)(ii)(B) and revising it;

k. Redesignating paragraph (j)(8)(i) as paragraph (j)(8)(i)(A);

l. Redesignating paragraph (j)(8)(i)(A) as paragraph (j)(8)(i)(A)(1);

m. Redesignating paragraph (j)(8)(i)(B) as paragraph (j)(8)(i)(A)(2);

n. Designating the undesignated paragraph following paragraph (j)(8)(i)(B) as paragraph

(j)(8)(i)(B);

o. Redesignating paragraph (j)(8)(ii) as paragraph (j)(8)(ii)(A);

p. Redesignating paragraph (j)(8)(ii)(A) as paragraph (j)(8)(ii)(A)(1);

q. Redesignating paragraph (j)(8)(ii)(B) as paragraph (j)(8)(ii)(A)(2); and

r. Designating the undesignated paragraph following paragraph (j)(8)(ii)(B) as paragraph

(j)(8)(ii)(B).

The proposed revisions and additions read as follows:

**§ 1.10 Financial reports of futures commission merchants and introducing brokers.**

(a) \* \* \*

(2) (i) (A) Except as provided in paragraphs (a)(3) and (h) of this section, each person who files an application for registration as a futures commission merchant and who is not so

registered at the time of such filing, must, concurrently with the filing of such application file either:

(1) A Form 1-FR-FCM certified by an independent public accountant in accordance with §1.16 as of a date not more than 45 days prior to the date on which such report is filed; or

(2) A Form 1-FR-FCM as of a date not more than 17 business days prior to the date on which such report is filed and a Form 1-FR-FCM certified by an independent public accountant in accordance with § 1.16 as of a date not more than one year prior to the date on which such report is filed.

(B) Each such person must include with such financial report a statement describing the source of his current assets and representing that his capital has been contributed for the purpose of operating his business and will continue to be used for such purpose.

(ii) (A) Except as provided in paragraphs (a)(3) and (h) of this section, each person who files an application for registration as an introducing broker and who is not so registered at the time of such filing, must, concurrently with the filing of such application file either:

(1) A Form 1-FR-IB certified by an independent public accountant in accordance with §1.16 as of a date not more than 45 days prior to the date on which such report is filed;

(2) A Form 1-FR-IB as of a date not more than 17 business days prior to the date on which such report is filed and a Form 1-FR-IB certified by an independent public accountant in accordance with §1.16 as of a date not more than one year prior to the date on which such report is filed;

(3) A Form 1-FR-IB as of a date not more than 17 business days prior to the date on which such report is filed, Provided, however, that such applicant shall be subject to a review by the applicant's designated self-regulatory organization within six months of registration; or

(4) A guarantee agreement.

(B) Each person filing in accordance with paragraphs (a)(2)(ii)(A) (1), (2) or (3) of this section must include with such financial report a statement describing the source of his current assets and representing that his capital has been contributed for the purpose of operating his business and will continue to be used for such purpose.

\* \* \* \* \*

(j) \*\*\*

(8)(i)(A) An introducing broker which is a party to a guarantee agreement which has been terminated in accordance with the provisions of paragraph (j)(5) of this section, or which is due to expire in accordance with the provisions of paragraph (j)(4)(ii) of this section, must cease doing business as an introducing broker on or before the effective date of such termination or expiration unless, on or before 10 days prior to the effective date of such termination or expiration or such other period of time as the Commission or the designated self-regulatory organization may allow for good cause shown, the introducing broker files with its designated self-regulatory organization either a new guarantee agreement effective as of the day following the date of termination of the existing agreement, or, in the case of a guarantee agreement which is due to expire in accordance with the provisions of paragraph (j)(4)(ii) of this section, a new guarantee agreement effective on or before such expiration, or either:

(1) A Form 1-FR-IB certified by an independent public accountant in accordance with § 1.16 as of a date not more than 45 days prior to the date on which the report is filed; or

(2) A Form 1-FR-IB as of a date not more than 17 business days prior to the date on which the report is filed and a Form 1-FR-IB certified by an independent public accountant in

accordance with § 1.16 as of a date not more than one year prior to the date on which the report is filed.

(B) Each person filing a Form 1-FR-IB in accordance with this section must include with the financial report a statement describing the source of his current assets and representing that his capital has been contributed for the purpose of operating his business and will continue to be used for such purpose.

(ii) (A) Notwithstanding the provisions of paragraph (j)(8)(i) of this section or of § 1.17(a), an introducing broker that is a party to a guarantee agreement that has been terminated in accordance with the provisions of paragraph (j)(5)(ii) of this section shall not be deemed to be in violation of the minimum adjusted net capital requirement of § 1.17(a)(1)(ii) or (a)(2) for 30 days following such termination. Such an introducing broker must cease doing business as an introducing broker on or after the effective date of such termination, and may not resume doing business as an introducing broker unless and until it files a new agreement or either:

(1) A Form 1-FR-IB certified by an independent public accountant in accordance with § 1.16 of this part as of a date not more than 45 days prior to the date on which the report is filed; or

(2) A Form 1-FR-IB as of a date not more than 17 business days prior to the date on which the report is filed and a Form 1-FR-IB certified by an independent public accountant in accordance with § 1.16 as of a date not more than one year prior to the date on which the report is filed.

(B) Each person filing a Form 1-FR-IB in accordance with this section must include with the financial report a statement describing the source of his current assets and representing that

his capital has been contributed for the purpose of operating his business and will continue to be used for such purpose.

\* \* \* \* \*

4. Section 1.17 is amended by redesignating paragraph (a)(1)(ii) as (a)(1)(iii) and by adding new paragraph (a)(1)(ii) to read as follows:

**§ 1.17 Minimum financial requirements for futures commission merchants and introducing brokers.**

(a) \* \* \*

(1) \* \* \*

(ii) Each person registered as a futures commission merchant engaged in soliciting or accepting orders and customer funds related thereto for the purchase or sale of any commodity for future delivery or any commodity option on or subject to the rules of a registered derivatives transaction execution facility from any customer who does not qualify as an “institutional customer” as defined in §1.3(g) must:

(A) Be a clearing member of a derivatives clearing organization and maintain net capital in the amount of the greater of \$20,000,000 or the amounts otherwise specified in paragraph (a)(1)(i) of this section; or

(B) Receive orders on behalf of the customer from a commodity trading advisor acting in accordance with § 4.32 of this chapter.

\* \* \* \* \*

5. Section 1.33 is amended by adding a new paragraph (g) to read as follows:

**§ 1.33 Monthly and confirmation statements.**

\* \* \* \* \*

(g) Electronic transmission of statements. (1) The statements required by this section, and by § 1.46, may be furnished to any customer by means of electronic media if the customer so consents, Provided, however, that a futures commission merchant must, prior to the transmission of any statement by means of electronic media, disclose the electronic medium or source through which statements will be delivered, the duration, whether indefinite or not, of the period during which consent will be effective, any charges for such service, the information that will be delivered by such means, and that consent to electronic delivery may be revoked at any time.

(2) In the case of a customer who does not qualify as an “institutional customer” as defined in § 1.3(g), a futures commission merchant must obtain the customer’s signed consent acknowledging disclosure of the information set forth in paragraph (g)(1) of this section prior to the transmission of any statement by means of electronic media.

(3) Any statement required to be furnished to a person other than a customer in accordance with paragraph (d) of this section may be furnished by electronic media.

(4) A futures commission merchant who furnishes statements to any customer by means of electronic media must retain a daily confirmation statement for such customer as of the end of the trading session, reflecting all transactions made during that session for the customer, in accordance with § 1.31.

\* \* \* \* \*

6. Section 1.46 is amended as follows:

- a. By revising paragraph (a), introductory text,
- b. By removing and reserving paragraphs (d)(4) through (d)(7),
- c. By removing paragraph (d)(9) and
- d. By revising paragraph (e) to read as follows:

**§ 1.46 Application and closing out of offsetting long and short positions.**

(a) Application of purchases and sales. Except with respect to purchases or sales which are for omnibus accounts, or where the customer has instructed otherwise, any futures commission merchant who, on or subject to the rules of a designated contract market or registered derivatives transaction execution facility:

\* \* \* \* \*

(e) The statements required by paragraph (a) of this section may be furnished to the customer or the person described in § 1.33(d) by means of electronic transmission, in accordance with § 1.33(g).

\* \* \* \* \*

7. Section 1.55 is amended by revising paragraphs (d) and (f) to read as follows:

**§ 1.55 Distribution of “Risk Disclosure Statement” by futures commission merchants and introducing brokers.**

\* \* \* \* \*

(d) Any futures commission merchant, or in the case of an introduced account any introducing broker, may open a commodity futures account for a customer without obtaining the separate acknowledgments of disclosure and elections required by this section and by § 1.33(g), and by §§ 33.7 and 190.06 of this chapter, provided that:

(1) Prior to the opening of such account, the futures commission merchant or introducing broker obtains an acknowledgment from the customer, which may consist of a single signature at the end of the futures commission merchant’s or introducing broker’s customer account agreement, or on a separate page, of the disclosure statements and elections specified in this section and § 1.33(g), and in §§ 33.7 and 190.06 of this chapter, and which may include

authorization for the transfer of funds from a segregated customer account to another account of such customer, as listed directly above the signature line, provided the customer has acknowledged by check or other indication next to a description of each specified disclosure statement or election that the customer has received and understood such disclosure statement or made such election;

(2) The acknowledgment referred to in paragraph (d)(1) of this section must be accompanied by and executed contemporaneously with delivery of the disclosures and elective provisions required by this section and § 1.33(g), and by §§ 33.7 and 190.06 of this chapter.

\* \* \* \* \*

(f) A futures commission merchant or, in the case of an introduced account an introducing broker, may open a commodity futures account for an “institutional customer” as defined in §1.3(g) without furnishing such institutional customer the disclosure statements or obtaining the acknowledgements required under paragraph (a) of this section, §§ 1.33(g) and 1.65(a)(3), and §§ 30.6(a), 33.7(a) and 190.10(c) of this chapter.

\* \* \* \* \*

### **PART 3--REGISTRATION**

8. The authority citation for Part 3 is revised to read as follows:

**Authority:** 5 U.S.C. 522, 522b; 7 U.S.C. 1a, 2, 6, 6a, 6b, 6c, 6d, 6e, 6f, 6g, 6h, 6i, 6k, 6m, 6n, 6o, 6p, 8, 9, 9a, 12, 12a, 13b, 13c, 16a, 18, 19, 21, 23.

9. Section 3.1 is amended by revising paragraphs (a)(1) and (a)(2) to read as follows:

#### **§ 3.1 Definitions.**

(a) \* \* \*

(1) If the entity is organized as a sole proprietorship, the proprietor; if a partnership, any general partner; if a corporation, any director, the president, chief executive officer, chief operating officer, chief financial officer, and any person in charge of a principal business unit, division or function subject to regulation by the Commission; if a limited liability company or limited liability partnership, any director, the president, chief executive officer, chief operating officer, chief financial officer, the manager, managing member or those members vested with the management authority for the entity, and any person in charge of a principal business unit, division or function subject to regulation by the Commission; and, in addition, any person occupying a similar status or performing similar functions, having the power, directly or indirectly, through agreement or otherwise, to exercise a controlling influence over the entity's activities that are subject to regulation by the Commission;

(2)(i) Any individual who directly or indirectly, through agreement, holding company, nominee, trust or otherwise, is the owner of ten percent or more of the outstanding shares of any class of stock, is entitled to vote or has the power to sell or direct the sale of ten percent or more of any class of voting securities, or is entitled to receive ten percent or more of the profits; or

(ii) Any person other than an individual that is the direct owner of ten percent or more of any class of securities; or

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10. Section 3.10 is amended by redesignating paragraph (a)(2)(i) as paragraph (a)(2) and by removing paragraph (a)(2)(ii).

11. Section 3.21 is amended by revising paragraph (c) introductory text to read as follows:

**§ 3.21 Exemption from fingerprinting requirement in certain cases.**

\* \* \* \* \*

(c) Outside directors. Any futures commission merchant, introducing broker, commodity trading advisor, commodity pool operator or leverage transaction merchant that has a principal who is a director but is not also an officer or employee of the firm may, in lieu of submitting a fingerprint card in accordance with the provisions of §§ 3.10(a)(2) and 3.31(a)(2), file a “Notice Pursuant to Rule 3.21(c)” with the National Futures Association. Such notice shall state, if true, that such outside director:

\* \* \* \* \*

12. Section 3.31 is amended by redesignating paragraph (a) as paragraph (a)(1), and by adding new paragraph (a)(2) to read as follows:

**§ 3.31 Deficiencies, inaccuracies, and changes, to be reported.**

(a) (1) \* \* \*

(2) Where the deficiency or inaccuracy is created by the addition of a new principal not listed on the registrant’s application for registration (or amendment of such application prior to the granting of registration), each Form 3-R filed in accordance with the requirements of paragraph (a)(1) of this section must be accompanied by a Form 8-R, completed in accordance with the instructions thereto and executed by each natural person who is a principal of the registrant and who was not listed on the registrant’s initial application for registration or any amendment thereto. The Form 8-R for each such principal must be accompanied by the fingerprints of that principal on a fingerprint card provided by the National Futures Association for that purpose, unless such principal is a director who qualifies for the exemption from the fingerprint requirement pursuant to § 3.21(c). The provisions of this paragraph do not apply to

any principal who has a current Form 8-R on file with the Commission or the National Futures Association.

\* \* \* \* \*

**§ 3.32 [Removed]**

13. Section 3.32 is removed.

**§ 3.34 [Removed]**

14. Section 3.34 is removed.

15. Appendix A to Part 3 is amended by adding to the end thereto the following:

[APPENDIX A TO PART 3 – INTERPRETATIVE STATEMENT WITH RESPECT TO SECTION 8A(2)(C) AND (E) AND SECTION 8A(3)(J) AND (M) OF THE COMMODITY EXCHANGE ACT]

\* \* \* \* \*

The Commission has further addressed “other good cause” under Section 8a(3)(M) of the Act in issuing guidance letters on assessing the fitness of floor brokers, floor traders or applicants in either category:

[First guidance letter]

December 4, 1997

Robert K. Wilmouth  
President  
National Futures Association  
200 West Madison Street  
Chicago, IL 60606-3447

Re: Adverse Registration Actions with Respect to Floor Brokers, Floor Traders and Applicants for Registration in Either Category

Dear Mr. Wilmouth:

As you know, the Commission on June 26, 1997, approved for publication in the Federal Register a Notice and Order concerning adverse registration actions by the National Futures Association (“NFA”) with respect to registered floor brokers (“FBs”), registered floor traders (“FTs”) and applicants for registration in either category. 62 Fed. Reg. 36050 (July 3, 1997). The Notice and Order authorized NFA to grant or to maintain, either with or without conditions or restrictions, FB or FT registration where NFA previously would have forwarded the case to the Commission for review of disciplinary history. The Commission has worked with its staff to determine which of the pending matters could efficiently be returned to NFA for handling, and such matters have been forwarded to NFA. The Commission will continue to accept or to act upon requests for exemption, and the Commission staff will consider requests for “no-action” opinions with respect to applicable registration requirements.

By this correspondence, the Commission is issuing guidance that provides NFA further direction on how it expects NFA to exercise its delegated power, based upon the experience of the Commission and the staff with the registration review process during the past three years. This guidance will help ensure that NFA exercises its delegated power in a manner consistent with Commission precedent.

In exercising its delegated authority, NFA, of course, needs to apply all of the provisions of Sections 8a(2) and (3) of the Commodity Exchange Act (“Act”).<sup>1</sup> In that regard, NFA should consider the matters in which the Commission has taken action in the past and endeavor to seek

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<sup>1</sup> 7 U.S.C. 12a(2) and (3) (1994). The letter is intended to supplement, not to supersede, other guidance provided in the past to NFA. In this regard, the NFA should continue to follow other guidance provided by the Commission or its staff.

similar registration restrictions, conditions, suspensions, denials, or revocations under similar circumstances.

One of the areas in which NFA appears to have had the most uncertainty is with regard to previous self-regulatory organization (“SRO”) disciplinary actions. Commission Rule 1.63<sup>2</sup> provides clear guidelines for determining whether a person’s history of “disciplinary offenses” should preclude service on SRO governing boards or committees.<sup>3</sup> In determining whether to grant or to maintain, either with or without conditions or restrictions, FB or FT registration, NFA should, as an initial matter, apply the Rule 1.63(a)(6) criteria to those registered FBs, registered FTs and applicants for registration in either category. However, NFA should be acting based upon any such offenses that occurred within the previous five years, rather than the three years provided for in Rule 1.63(c). NFA should consider disciplinary actions taken by an SRO as that term is defined in Section 3(a)(26) of the Securities Exchange Act of 1934 no differently from

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<sup>2</sup> Commission rules referred to herein are found at 17 CFR Ch. I.

<sup>3</sup> Rule 1.63(c) provides that a person is ineligible from serving on an SRO’s disciplinary committees, arbitration panels, oversight panels or governing board if, as provided in Rule 1.63(b), the person, inter alia: (1) within the past three years has been found by a final decision of an SRO, an administrative law judge, a court of competent jurisdiction or the Commission to have committed a disciplinary offense; or (2) within the past three years has entered into a settlement agreement in which any of the findings or, in the absence of such findings, any of the acts charged included a disciplinary offense.

Rule 1.63(a)(6) provides that a “disciplinary offense” includes: (i) any violation of the rules of an SRO except those rules related to (A) decorum or attire, (B) financial requirements, or (C) reporting or record-keeping unless resulting in fines aggregating more than \$5,000 within any calendar year; (ii) any rule violation described in subparagraphs (A) through (C) above that involves fraud, deceit or conversion or results in a suspension or expulsion; (iii) any violation of the Act or the regulations promulgated thereunder; or (iv) any failure to exercise supervisory responsibility with respect to an act described in paragraphs (i) through (iii) above when such failure is itself a violation of either the rules of an SRO, the Act or the regulations promulgated thereunder.

disciplinary actions taken by an SRO in the futures industry as defined in Rule 1.3(ee).<sup>4</sup> Application of the Rule 1.63 criteria, as modified, to these matters will aid NFA in making registration determinations that are reasonably consonant with Commission views.<sup>5</sup> NFA should focus on the nature of the underlying conduct rather than the sanction imposed by an SRO. Thus, if a disciplinary action would not come within the coverage of Rule 1.63 but for the imposition of a short suspension of trading privileges (such as for a matter involving fighting, use of profane language or minor recordkeeping violations), NFA could exercise discretion, as has the Commission, not to institute a statutory disqualification case. On the other hand, conduct that falls clearly within the terms of Rule 1.63, such as violations of rules involving potential harm to customers of the exchange, should not be exempt from review simply because the exchange imposed a relatively minor sanction.

The Commission has treated the registration process and the SRO disciplinary process as separate matters involving separate considerations. The fact that the Commission has not pursued its own enforcement case in a particular situation does not necessarily mean that the Commission considers the situation to be a minor matter for which no registration sanctions are appropriate. Further, the Commission believes that it and NFA, entities with industry-wide perspective and responsibilities, are the appropriate bodies, rather than any individual exchange,

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<sup>4</sup> Thus, for example, a disciplinary action taken by the Chicago Board Options Exchange or the National Association of Securities Dealers, Inc. should be considered in a manner similar to a disciplinary action of the Chicago Board of Trade or NFA.

<sup>5</sup> In reviewing these matters, the NFA should bear in mind recent Commission precedent which allows for reliance on settled disciplinary proceedings in some circumstances. See In the Matter of Michael J. Clark, [1996-1998 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 27,032 (Apr. 22, 1997) (“other good cause” under Section 8a(3)(M) of the Act exists based upon a pattern of exchange disciplinary actions resulting in significant sanctions for serious rule violations--whether settlements or adjudications), aff’d sub nom., Clark v. Commodity Futures Trading Commission, No. 97-4228 (2d Cir. June 4, 1999) (unpublished).

to decide issues relating to registration status, which can affect a person's ability to function in the industry well beyond the jurisdiction of a particular exchange. Thus, NFA's role is in no way related to review of exchange sanctions for particular conduct, but rather it is the entirely separate task of determining whether an FB's or FT's conduct should impact his or her registration.

NFA also should look to Commission precedent in selecting conditions or restrictions to be imposed, such as a dual trading ban where a person has been involved in disciplinary offenses involving customer abuse. Where conditions or restrictions are imposed, or agreed upon, NFA also should follow Commission precedent, under which such conditions or restrictions generally have been imposed for a two-year period.

The Commission has required sponsorship for conditioned FBs and FTs when their disciplinary offenses have involved noncompetitive trading and fraud irrespective of the level of sanctions imposed by an SRO. Indeed, but for a sponsorship requirement there would be no one routinely watching and responsible for the activities of these registrants. Absent sponsorship, such FBs and FTs would only be subject to routine Commission and exchange surveillance. The Commission's rules are premised upon the judgment that requiring FTs and FBs to have sponsors to ensure their compliance with conditions is both appropriate and useful. See Rule 3.60(b)(2)(i).

A question has arisen whether, if NFA is required to prove up the underlying facts of an SRO disciplinary action, the exchanges can provide information on exchange disciplinary proceedings directly to NFA. Although Section 8c(a)(2) of the Act states that an exchange shall not disclose the evidence for a disciplinary action except to the person disciplined and to the

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Commission, Section 8a(10) of the Act allows the Commission to authorize any person to perform any portion of the registration functions under the Act, notwithstanding any other provision of law. The effective discharge of the delegated registration function requires NFA to have access to the exchange evidence. Thus, the Commission believes that Section 8a(10) may reasonably be interpreted to allow the disclosure of information from exchange disciplinary proceedings directly to NFA despite the provisions of Section 8c(a)(2).

Nothing in the Notice and Order affects the Commission's authority to review the granting of a registration application by NFA in the performance of Commission registration functions, including review of the sufficiency of conditions or restrictions imposed by NFA, to review the determination by NFA not to take action to affect an existing registration, or to take its own action to address a statutory disqualification. Moreover, the Commission Order contemplates that to allow for appropriate Commission oversight of NFA's exercise of this delegated authority, NFA will provide for the Commission's review quarterly schedules of all applicants cleared for registration and all registrants whose registrations are maintained without adverse action by NFA's Registration, Compliance, Legal Committee despite potential statutory disqualifications.

The Commission will continue to monitor NFA activities through periodic rule enforcement reviews, and NFA remains subject to the present requirement that it monitor compliance with the conditions and restrictions imposed on conditioned and restricted registrants.

Sincerely,

Jean A. Webb,  
Secretary of the Commission.

[Second guidance letter]

April 13, 2000

Robert K. Wilmouth  
President  
National Futures Association  
200 West Madison Street  
Chicago, IL 60606-3447

Re: Use of Exchange Disciplinary Actions as “Other Good Cause” to Affect Floor Broker/Floor Trader Registration

Dear Mr. Wilmouth:

I. **INTRODUCTION AND BACKGROUND**

In July 1997, the Commission issued a Notice and Order authorizing the National Futures Association (“NFA”) to grant or to maintain, either with or without conditions or restrictions, floor broker (“FB”) or floor trader (“FT”) registration where NFA previously would have forwarded the case to the Commission for review of disciplinary history.<sup>1</sup> By letter dated December 4, 1997 (“Guidance Letter”), the Commission provided further direction on how the Commission expected NFA to exercise its delegated power and to ensure that NFA exercised its delegated power in a manner consistent with Commission precedent.

The Commission has determined to revise the Guidance Letter. Specifically, the Commission is revising the portion of the Guidance Letter that addresses the use of exchange disciplinary actions as “other good cause” to affect FB and FT registrations. The Commission

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<sup>1</sup> Registration Actions by National Futures Association With Respect to Floor Brokers, Floor Traders and Applicants for Registration in Either Category, 62 FR 36050 (July 3, 1997).

has made this determination following its own reconsideration of the issue and at the urging of industry members.<sup>2</sup>

The Guidance Letter pointed out that, in exercising its delegated authority, NFA must apply all of the provisions of Sections 8a(2) and (3) of the Commodity Exchange Act (“Act”).<sup>3</sup> In particular, Section 8a(3)(M) of the Act authorizes the Commission to refuse to register or to register conditionally any person if it is found, after opportunity for hearing, that there is other good cause for statutory disqualification from registration beyond the specifically listed grounds in Sections 8a(2) and 8a(3) of the Act. The Commission held in In the Matter of Clark that statutory disqualification under the “other good cause” provision of Section 8a(3)(M) may arise on the basis of, among other things, a pattern of exchange disciplinary actions alleging serious rule violations that result in significant sanctions, and that it is immaterial whether the sanctions imposed resulted from a fully-adjudicated disciplinary action or an action that was taken following a settlement.<sup>4</sup>

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<sup>2</sup> See letters submitted by James Bowe, former president of the New York Board of Trade (“NYBOT”), dated October 13, 1999, Christopher Bowen, general counsel of the New York Mercantile Exchange (“NYMEX”), dated October 18, 1999, and the Joint Compliance Committee (“JCC”), dated February 2, 2000. The JCC consists of senior compliance officials from all domestic futures exchanges and the NFA (*i.e.*, the domestic self-regulatory organizations (“SROs”). In addition, staff from the Contract Markets Section of the Commission’s Division of Trading and Markets attend the JCC meetings as observers. The JCC was established to aid in the development of improved compliance systems through joint efforts and information-sharing among the SROs. Commission staff have also discussed this issue with SRO staff.

<sup>3</sup> 7 U.S.C. 12a(2) and (3) (1994).

<sup>4</sup> In the Matter of Clark, [1996-1998 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 27,032 (Apr. 22, 1997), *aff’d sub nom., Clark v. Commodity Futures Trading Commission*, No. 97-4228 (2d Cir. June 4, 1999) (unpublished).

The Guidance Letter recommended the application of the provisions of Commission Rule 1.63<sup>5</sup> as criteria to aid in assessing the impact of an FB or FT applicant's or registrant's previous disciplinary history on the person's fitness to be registered, with the exception that NFA should be acting based on disciplinary history from the previous five years, rather than the three years provided for in Rule 1.63.<sup>6</sup> The Guidance Letter also noted that NFA should consider disciplinary actions taken not only by futures industry SROs but also those taken by SROs as defined in Section 3(a)(26) of the Securities Exchange Act of 1934 ("1934 Act"), including settled disciplinary actions.

## II. REVISED GUIDANCE

As stated above, the Commission has determined to revise the Guidance Letter. From this point forward, NFA should cease using Rule 1.63 as the basis to evaluate the impact of an FB or FT applicant's or registrant's disciplinary history on his or her fitness to be registered. Instead, as Clark stated, when reviewing disciplinary history to assess the fitness to be registered

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<sup>5</sup> Commission rules referred to in this letter are found at 17 CFR Ch. 1.

<sup>6</sup> Rule 1.63 provides, among other things, that a person is ineligible from serving on SRO disciplinary committees, arbitration panels, oversight panels or governing boards if that person, inter alia, entered into a settlement agreement within the past three years in which any of the findings or, in the absence of such findings, any of the acts charged included a disciplinary offense.

Rule 1.63(a)(6) defines a "disciplinary offense" to include:

(i) any violation of the rules of an SRO except those rules related to (A) decorum or attire, (B) financial requirements, or (C) reporting or record-keeping unless resulting in fines aggregating more than \$5,000 within any calendar year; (ii) any rule violation described in subparagraphs (A) through (C) above that involves fraud, deceit or conversion or results in a suspension or expulsion; (iii) any violation of the Act or the regulations promulgated thereunder; or (iv) any failure to exercise supervisory responsibility with respect to an act described in paragraphs (i) through (iii) above when such failure is itself a violation of either the rules of an SRO, the Act or the regulations promulgated thereunder.

of an FB, FT, or applicant in either category, a pattern of exchange disciplinary actions alleging serious rule violations that result in significant sanctions will trigger the “other good cause” provision of Section 8a(3)(M). The “pattern” should consist of at least two final exchange disciplinary actions, whether settled or adjudicated.

NFA also should consider initiating proceedings to affect the registration of the FB or FT, even if there is only a single exchange action against the FB or FT, if the exchange action was based on allegations of particularly egregious misconduct or involved numerous instances of misconduct occurring over a long period of time. If, however, a proceeding is initiated based on a single exchange action that was disposed of by settlement, NFA may have to prove up the underlying misconduct. Furthermore, traditional principles of collateral estoppel apply to adjudicated actions, whether they are being considered individually or as part of a pattern.<sup>7</sup>

As provided by the Guidance Letter, “exchange disciplinary actions” would continue to include disciplinary actions taken by both futures industry SROs and SROs as defined in Section 3(a)(26) of the 1934 Exchange Act. Furthermore, NFA should review an applicant’s or registrant’s disciplinary history for the past five years.<sup>8</sup> At least one of the actions forming the pattern, however, must have become final after Clark was decided by the Commission on April

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<sup>7</sup> Clark at 44,929.

<sup>8</sup> The Commission generally looked at a five-year period of disciplinary history. On occasion, however, the Commission examined a longer period of an applicant’s or registrant’s disciplinary history. For example, the Commission revoked the registration of one FB on the basis of exchange disciplinary cases that extended back six years, see Clark, 2 Comm. Fut. L. Rep. (CCH) ¶ 27,032, and denied an application for registration as an FT on the basis of exchange disciplinary cases that extended back seven years, see In the Matter of Castellano, [1987–1990 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 24,360 (Nov. 23, 1988), summarily aff’d (May 29, 1990), reh. denied [1990–1992 Transfer Binder] Comm. Fut. L. Rep. ¶ 24,870 (June 26, 1990), aff’d sub nom. Castellano v. CFTC, Docket No. 90-2298 (7<sup>th</sup> Cir. Nov. 20, 1991).

22, 1997. Finally, “serious rule violations” consist of, or are substantially related to, charges of fraud, customer abuse, other illicit trading practices, or the obstruction of an exchange investigation.

Congress, the courts and the Commission have indicated the importance of considering an applicant’s history of exchange disciplinary actions in assessing that person’s fitness to register.<sup>9</sup> Furthermore, NFA’s review of exchange disciplinary actions within the context of the registration process should not simply mirror the disciplinary actions undertaken by the exchanges. The two processes are separate matters that involve separate considerations. As part of their ongoing self-regulatory obligations, exchanges must take disciplinary action<sup>10</sup> and such disciplinary matters necessarily focus on the specific misconduct that forms the allegation. In a statutory disqualification action, however, NFA must determine whether the disciplinary history of an FB, FT or applicant over the preceding five years should impact his or her registration. Additionally, NFA possesses industry-wide perspective and responsibilities. As such, NFA, rather than an individual exchange, should decide registration status issues, since those issues affect an individual’s status within the industry as a whole, well beyond the jurisdiction of a particular exchange.

The Commission also wants to clarify to the fullest extent possible that its power to delegate the authority to deny or condition the registration of an FB, FT, or an applicant for registration in either category permits exchanges to disclose to NFA all evidence underlying

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<sup>9</sup> Letter dated July 14, 1995, from Mary L. Schapiro to R. Patrick Thompson, President, New York Mercantile Exchange (unpublished). See also Castellano, supra note 8.

<sup>10</sup> See Rule 1.51(a)(7).

exchange disciplinary actions, notwithstanding the language of Section 8c(a)(2) of the Act.<sup>11</sup>

The Commission's power to delegate stems from Section 8a(10) of the Act, which permits delegation of registration functions, including statutory disqualification actions, to any person in accordance with rules adopted by such person and submitted to the Commission for approval or for review under Section 17(j) of the Act, "notwithstanding any other provision of law."

Certainly, Section 8c(a)(2) qualifies as "any other provision of law." Furthermore, the effective discharge of the delegated function requires NFA to have access to the exchange evidence.

Thus, the exercise of the delegated authority pursuant to Section 8a(10) permits the exchanges to disclose all evidence underlying disciplinary actions to NFA.<sup>12</sup>

This letter supersedes the Guidance Letter to the extent discussed above. In all other aspects, the Guidance Letter and other guidance provided by the Commission or its staff remain in effect. Therefore, NFA should continue to follow Commission precedent when selecting conditions or restrictions to be imposed. For example, NFA should impose a dual trading ban where customer abuse is involved and any conditions or restrictions imposed should be for a two-year period. Furthermore, NFA should require sponsorship for conditioned FBs or FTs when their disciplinary offenses involve noncompetitive trading and fraud.

Nothing in the Notice and Order or this letter affects the Commission's authority to review the granting of a registration application by NFA in the performance of Commission

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<sup>11</sup> Section 8c(a)(2) states, in relevant part, that "[A]n exchange...shall not disclose the evidence therefor, except to the person who is suspended, expelled, disciplined, or denied access, and to the Commission."

<sup>12</sup> Of course, the Commission could request records from the exchange and forward them to NFA. The Commission believes that this is an unnecessary administrative process and that NFA should obtain the records it needs to carry out the delegated function of conducting disciplinary history reviews directly from the exchanges. In this context and pursuant to Commission orders

registration functions, including review of the sufficiency of conditions or restrictions imposed by NFA, to review the determination by NFA not to take action to affect an existing registration, or to take its own action to address a statutory disqualification. Moreover, the Commission Order contemplates that to allow for appropriate Commission oversight of NFA's exercise of this delegated authority, NFA will provide for the Commission's review quarterly schedules of all applicants cleared for registration and all registrants whose registrations are maintained without adverse action by NFA's Registration, Compliance, Legal Committee despite potential statutory disqualifications.

The Commission will continue to monitor NFA activities through periodic rule enforcement reviews, and NFA remains subject to the present requirement that it monitor compliance with the conditions and restrictions imposed on conditioned and restricted registrants.

Sincerely,

Jean A. Webb

Secretary of the Commission

16. Part 3 is amended by adding Appendix B to read as follows:

**APPENDIX B TO PART 3—STATEMENT OF ACCEPTABLE PRACTICES WITH RESPECT TO ETHICS TRAINING**

(a) The provisions of Section 4p(b) of the Act (7 U.S.C. 6p(b) (1994)) set forth requirements regarding training of registrants as to their responsibilities to the public. This section requires the Commission to issue regulations requiring new registrants to attend ethics training sessions within six months of registration, and all registrants to attend such training on a

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authorizing NFA to institute adverse registration actions, NFA should be viewed as standing in

periodic basis. The awareness and maintenance of professional ethical standards are essential elements of a registrant's fitness. Further, the use of ethics training programs is relevant to a registrant's maintenance of adequate supervision, a requirement under Rule 166.3.

(b)(1) The Commission recognizes that technology has provided new, faster means of sharing and distributing information. In view of the foregoing, the Commission has chosen to allow registrants to develop their own ethics training programs. Nevertheless, futures industry professionals may want guidance as to the role of ethics training. Registrants may wish to consider what ethics training should be retained, its format, and how it might best be implemented. Therefore, the Commission finds it appropriate to issue this Statement of Acceptable Practices regarding appropriate training for registrants, as interpretative guidance for intermediaries on fitness and supervision. Commission registrants may look to this Statement of Acceptable Practices as a "safe harbor" concerning acceptable procedures in this area.

(2) The Commission believes that section 4p(b) of the Act reflects an intent by Congress that industry professionals be aware, and remain abreast, of their continuing obligations to the public under the Act and the regulations thereunder. The text of the Act provides guidance as to the nature of these responsibilities. As expressed in section 4p(b) of the Act, personnel in the industry have an obligation to the public to observe the Act, the rules of the Commission, the rules of any appropriate self-regulatory organizations or contract markets (which would also include registered derivatives transaction execution facilities), or other applicable federal or state laws or regulations. Further, section 4p(b) acknowledges that registrants have an obligation to the public to observe "just and equitable principles of trade."

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the shoes of the Commission.

(3) Additionally, section 4p(b) reflects Congress' intent that registrants and their personnel retain an up-to-date knowledge of these requirements. The Act requires that registrants receive training on a periodic basis. Thus, it is the intent of Congress that Commission registrants remain current with regard to the ethical ramifications of new technology, commercial practices, regulations, or other changes.

(c) The Commission believes that training should be focused to some extent on a person's registration category, although there will obviously be certain principles and issues common to all registrants and certain general subjects that should be taught. Topics to be addressed include:

(1) An explanation of the applicable laws and regulations, and the rules of self-regulatory organizations or contract markets and registered derivatives transaction execution facilities;

(2) The registrant's obligation to the public to observe just and equitable principles of trade;

(3) How to act honestly and fairly and with due skill, care and diligence in the best interests of customers and the integrity of the market;

(4) How to establish effective supervisory systems and internal controls;

(5) Obtaining and assessing the financial situation and investment experience of customers;

(6) Disclosure of material information to customers; and

(7) Avoidance, proper disclosure and handling of conflicts of interest.

(d) An acceptable ethics training program would apply to all of a firm's associated persons and its principals to the extent they are required to register as associated persons.

Additionally, personnel of firms that rely on their registration with other regulators, such as the

Securities and Exchange Commission, should be provided with ethics training to the extent the Act and the Commission's regulations apply to their business.

(e) As to the providers of such training, the Commission believes that classes sponsored by independent persons, firms, or industry associations would be acceptable. It would also be permissible to conduct in-house training programs. Further, registrants should ascertain the credentials of any ethics training providers they retain. Thus, persons who provide ethics training should be required to provide proof of satisfactory completion of the proficiency testing requirements applicable to the registrant and evidence of three years of relevant industry or pedagogical experience in the field. This industry experience might include the practice of law in the fields of futures or securities, or employment as a trader or risk manager at a brokerage or end-user firm. Likewise, the Commission believes that registrants should employ as ethics training providers only those persons they reasonably believe in good faith are not subject to any investigations or to bars to registration or to service on a self-regulatory organization governing board or disciplinary panel.

(f)(1) With regard to the frequency and duration of ethics training, it is permissible for a firm to require training on whatever periodic basis and duration the registrant (and relevant self-regulatory organizations) deems appropriate. It may even be appropriate not to require any such specific requirements as, for example, where ethics training could be termed ongoing. For instance, a small entity, sole proprietorship, or even a small section in an otherwise large firm, might satisfy its obligation to remain current with regard to ethics obligations by distribution of periodicals, legal cases, or advisories. Use of the latest information technology, such as Internet websites, can be useful in this regard. In such a context, there would be no structured classes,

but the goal should be a continuous awareness of changing industry standards. A corporate culture to maintain high ethical standards should be established on a continuing basis.

(2) On the other hand, larger firms which transact business with a larger segment of the public may wish to implement a training program that requires periodic classwork. In such a situation, the Commission believes it appropriate for registrants to maintain such records as evidence of attendance and of the materials used for training. In the case of a floor broker or floor trader, the applicable contract market or registered derivatives transaction execution facility should maintain such evidence on behalf of its member. This evidence of ethics training could be offered to demonstrate fitness and overall compliance during audits by self-regulatory organizations, and during reviews of contract market or registered derivatives transaction execution facility operations.

(g) The methodology of such training may also be flexible. Recent innovations in information technology have made possible new, fast, and cost-efficient ways for registrants to maintain their awareness of events and changes in the commodity interest markets. In this regard, the Commission recognizes that the needs of a firm will vary according to its size, personnel, and activities. No format of classes will be required. Rather, such training could be in the form of formal class lectures, video presentation, Internet transmission, or by simple distribution of written materials. These options should provide sufficiently flexible means for adherence to Congressional intent in this area.

(h) Finally, it should be noted that self-regulatory organizations and industry associations will have a significant role in this area. Such organizations may have separate ethics and proficiency standards, including ethics training and testing programs, for their own members.

**PART 4--COMMODITY POOL OPERATORS AND COMMODITY TRADING  
ADVISORS**

17. The authority citation for Part 4 continues to read as follows:

**Authority:** 7 U.S.C. 1a, 2, 6b, 6c, 6l, 6m, 6n, 6o, 12a, and 23.

18. Section 4.10 is amended by revising paragraph (e)(1) to read as follows:

**§ 4.10 Definitions.**

\* \* \* \* \*

(e)(1) Principal, when referring to a person that is a principal of a particular entity, shall have the same meaning as the term “principal” under § 3.1(a) of this chapter.

\* \* \* \* \*

19. Section 4.24 is amended by revising paragraphs (f)(1)(v) and (h)(2) to read as follows:

**§ 4.24 General disclosures required.**

\* \* \* \* \*

(f) \* \* \*

(1) \* \* \*

(v) Each principal of the persons referred to in this paragraph (f)(1) who participates in making trading or operational decisions for the pool or who supervises persons so engaged.

\* \* \* \* \*

(h) \* \* \*

(2) A description of the trading and investment programs and policies that will be followed by the offered pool, including the method chosen by the pool operator concerning how futures commission merchants carrying the pool’s accounts shall treat offsetting positions

pursuant to § 1.46 of this chapter, if the method is other than to close out all offsetting positions or to close out offsetting positions on other than a first-in, first-out basis, and any material restrictions or limitations on trading required by the pool's organizational documents or otherwise. This description must include, if applicable, an explanation of the systems used to select commodity trading advisors, investee pools and types of investment activity to which pool assets will be committed;

\* \* \* \* \*

20. Section 4.32 is added to read as follows:

**§ 4.32 Trading on a Registered Derivatives Transaction Execution Facility for Non-Institutional Customers.**

(a) A registered commodity trading advisor may enter trades on or subject to the rules of a registered derivatives transaction execution facility on behalf of a client who does not qualify as an "institutional customer" as defined in § 1.3(g) of this chapter, provided that the trading advisor:

(1) Directs the client's commodity interest account;

(2) Directs accounts containing total assets of not less than \$25,000,000 at the time the trade is entered; and

(3) Discloses to the client that the trading advisor may enter trades on or subject to the rules of a registered derivatives transaction execution facility on the client's behalf.

(b) The commodity interest account of a client described in paragraph (a) of this section must be carried by a registered futures commission merchant.

21. Section 4.34 is amended by revising paragraphs (f)(1)(ii) and (h) to read as follows:

**§ 4.34 General disclosures required.**

\* \* \* \* \*

(f) \* \* \*

(1) \* \* \*

(ii) Each principal of the trading advisor who participates in making trading or operational decisions for the trading advisor or supervises persons so engaged.

\* \* \* \* \*

(h) Trading program. A description of the trading program, which must include the method chosen by the commodity trading advisor concerning how futures commission merchants carrying accounts it manages shall treat offsetting positions pursuant to § 1.46 of this chapter, if the method is other than to close out all offsetting positions or to close out offsetting positions on other than a first-in, first-out basis, and the types of commodity interests and other interests the commodity trading advisor intends to trade, with a description of any restrictions or limitations on such trading established by the trading advisor or otherwise.

\* \* \* \* \*

## **PART 140--ORGANIZATION, FUNCTIONS AND PROCEDURES OF THE COMMISSION**

22. The authority citation for Part 140 continues to read as follows:

**Authority:** 7 U.S.C. 2, 12a.

23. Section 140.91 is amended by revising paragraph (a)(7) to read as follows:

### **§ 140.91 Delegation of authority to the Director of the Division of Trading and Markets.**

(a) \* \* \*

(7) All functions reserved to the Commission in § 1.25 of this chapter.

\* \* \* \* \*

## **PART 155--TRADING STANDARDS**

24. The authority citation for Part 155 continues to read as follows:

**Authority:** 7 U.S.C. 6b, 6c, 6g, 6j and 12a unless otherwise noted.

25. Section 155.6 is added to read as follows:

### **§ 155.6 Trading standards for the transaction of business on registered derivatives transaction execution facilities.**

(a) A futures commission merchant, or affiliated person thereof, transacting business on behalf of a customer who does not qualify as an “institutional customer” as defined in §1.3(g) on a registered derivatives transaction execution facility shall comply with the provisions of § 155.3.

(b) No futures commission merchant, introducing broker or affiliated person thereof shall misuse knowledge of any institutional customer’s order for execution on a registered derivatives transaction execution facility.

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**Catherine D. Dixon,**

Assistant Secretary of the Commission.

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