

Daniel J. Roth, Esq.
General Counsel
National Futures Association
200 West Madison Street
Chicago, Illinois 60606-3447

Re: National Futures Association: Proposed Amendments to NFA Bylaws 1101 and 1507; NFA Compliance Rules 1-1, 2-7, 2-8, 2-22, 2-26, 2-29, and 2-30; Section 1 of NFA's Code of Arbitration; and the Interpretive Notice Regarding Enhanced Supervisory Requirements; Proposed Adoption of New NFA Compliance Rule 2-37 and Three New Interpretive Notices to Comply with Provisions of the Commodity Futures Modernization Act of 2000 Regarding Security Futures Products

Dear Mr. Roth:

By letter dated July 20, 2001, the National Futures Association submitted to the Commission for its approval, pursuant to Section 17(j) of the Commodity Exchange Act (the "Act"), the above-referenced proposed amendments.

Please be advised that on this date the Commission has determined to approve the above-referenced proposed amendments pursuant to Section 17(j) of the Act.

Very truly yours,

Catherine D. Dixon
Assistant Secretary of the Commission

MEMORANDUM

TO: The Commission

FROM: Division of Trading and Markets

SUBJECT: Proposed Amendments to NFA Bylaws 1101 and 1507; NFA Compliance Rules 1-1, 2-7, 2-8, 2-22, 2-26, 2-29, and 2-30; Section 1 of NFA's Code of Arbitration; and the Interpretive Notice Regarding Enhanced Supervisory Requirements;
Proposed Adoption of New NFA Compliance Rule 2-37 and Three New Interpretive Notices.

RECOMMENDATION: That the Commission approve the above-referenced rule amendments and new rules.

OTHER OFFICES
CONSULTED: Division of Enforcement
Office of General Counsel

STAFF CONTACT: Michael A. Piracci (X-5446)

I. Introduction

By letter dated July 20, 2001, the National Futures Association ("NFA") submitted to the Commission for its review and approval, pursuant to Section 17(j) of the Commodity Exchange Act (the "Act"), proposed amendments to NFA Bylaws, Compliance Rules, Code of Arbitration, and Interpretive Notices, as well as a proposed new Compliance Rule 2-37 and three new Interpretive Notices. The NFA's Board of Directors approved the proposals on May 17, 2001, and NFA's Executive Committee, with the Board's authorization, modified them on July 19, 2001.

II. Description

Section 203 of the Commodity Futures Modernization Act of 2000 ("CFMA") amended Section 15A of the Securities Exchange Act of 1934 (the "Exchange Act") to add a new paragraph (k), which permits a registered futures association to be a registered national securities association for the limited purpose of regulating the activities of members who are registered as brokers or dealers ("BD") pursuant to Section 15(b)(11) of the Exchange Act.¹

Section 15A(k)(2) of the Exchange Act requires that NFA have anti-fraud, anti-manipulation, and customer protection rules applicable to SFPs that are reasonably comparable to those of NASD Regulation, Inc. ("NASDR"). NFA has proposed these rule changes to ensure that its rules are comparable to those of NASDR, so as to comply with Section 15A(k)(2) of the Exchange Act. NFA indicated that it was guided by the recommendations of SEC staff in developing the proposed rule changes. In particular, SEC staff indicated that NFA's rules should be comparable to NASDR rules that apply to options, including those that apply to writing options "since the risks of futures transactions are more similar to the risks of writing options than to the risks of purchasing [options]."

A. NFA Bylaw 1101

NFA Bylaw 1101 prohibits NFA members from doing business with persons who are not members of a registered futures association and are required to be registered with the Commission as an FCM, IB, CPO or CTA. Section 4f(a)(4)(C)(ii) of the Act, as amended by the CFMA, provides that a registered futures association may not prohibit members from doing business with a BD that is notice-registered as an FCM or IB for purposes of SFPs. NFA proposes to amend Bylaw 1101 accordingly.

¹ Section 15(b)(11) of the Exchange Act, also added by Section 203 of the CFMA, permits FCM and IB members of NFA to notice-register as BDs if their only securities-related activities involve security futures products ("SFPs").

B. NFA Bylaw 1507, Compliance Rule 1-1, and Code of Arbitration Section 1

NFA Bylaw 1507, Compliance Rule 1-1, and Section 1 of the NFA Code of Arbitration all contain a definition of "Futures." These proposed amendments would make clear that "Futures" include SFPs as defined in Section 1a(32) of the Act so that NFA's authority over its members' activities extends to SFP transactions. NFA also proposed to amend Compliance Rule 1-1 to add a definition of "Exchange Act."

C. NFA Compliance Rule 2-7

NFA Compliance Rule 2-7 provides for the proficiency requirements of branch office managers. The proposed amendment would require notice-registered BDs to designate at least one security futures principal who would be required to take the Futures Branch Manager Examination (Series 30). This is comparable to NASDR rules that require NASDR members who engage in options transactions to have at least one registered options principal. NFA is also proposing that the designated security futures principal, where SFPs are involved, review discretionary trades, approve promotional materials, and approve the opening of customer accounts. (NFA Compliance Rules 2-8(b), 2-29(e), and 2-30(j)(1)).

D. NFA Compliance Rules 2-22 and 2-26

NFA Compliance Rule 2-22 would be amended to prohibit members from representing that they have been sponsored, recommended, or approved by any federal or state regulatory body. NFA Compliance Rule 2-26 would be amended to include that any member who violates Commission Rules 1.57, 155.3 or 155.4 will be deemed to have violated an NFA requirement.²

E. NFA Compliance Rule 2-29

NFA Compliance Rule 2-29 provides standards regarding communications with the public and promotional materials. The proposed amendments to this rule would prohibit the use of testimonials in promotional materials that are not "representative of all reasonably comparable accounts." Additionally, the amendment would require that any testimonial include a statement that the testimonial is not indicative of future performance and that it is a paid testimonial, if applicable.

The proposed amendments would also add a new paragraph (j) to the rule, applicable to the security futures activities of notice-registered BDs, that would, among

² Commission Rule 1.57 governs the operations and activities of IBs, including requiring that all customer accounts be opened and carried with an FCM on a fully-disclosed basis and that customer orders be transmitted promptly for execution. Commission Rules 155.3 and 155.4 set forth the trading standards for FCMs and IBs, including the manner in which affiliated persons of an FCM or IB may open an account with another firm.

other things: (i) require promotional materials for trading programs to include the cumulative performance history of customers who have used the program; (ii) require the firm to, upon request, provide customers with supporting documentation for any claims, comparisons, statistics, etc., made in promotional materials; (iii) prohibit promotional material from referring to past trading recommendations, unless it describes all other recommendations made over the last year; (iv) require the disclosure of conflicts of interest when making a specific trading recommendation; and (v) require that all mass media advertising be submitted to NFA for review and approval.

F. NFA Compliance Rule 2-30

NFA Compliance Rule 2-30 provides that NFA Members must obtain certain information from a customer, including the customer's previous investment experience and estimated annual income and net worth.³ NASDR rules require more extensive information to be obtained from customers and that security options accounts be approved or disapproved based upon an evaluation of the customer's suitability to trade those products. Additionally, NASDR rules prohibit members from making recommendations to a customer that are unsuitable for that customer.

The proposed amendment to Compliance Rule 2-30 would provide that, with respect to accounts for SFPs, members must obtain more extensive information about their customers, including whether the customer's account is for speculative or hedging purposes, the customer's employment status, marital status, and number of dependents. Additionally, a security futures principal must approve or disapprove the customer's account and members would be prohibited from recommending a transaction or trading strategy without reasonable grounds for believing the recommendation is not unsuitable.⁴

G. NFA Compliance Rule 2-37

Proposed new NFA Compliance Rule 2-37 would apply only to the security futures activities of NFA members that are notice-registered BDs. As required by Section 15A(k)(2)(A) of the Exchange Act, the rule would require these members to comply with, and have procedures in place to achieve such compliance with, the provisions of the securities laws applicable to SFPs. The rule would also require that these members annually provide customers with written information about NFA's Background Affiliation Status Information Center ("BASIC"). Additionally, the rule would require that these members file quarterly reports with NFA containing statistical information about written customer complaints received.

³ NFA Compliance Rule 2-30 also requires that members provide customers with a risk disclosure statement.

⁴ Section 2(a)(1)(D)(i)(V) of the Act prohibits FCMs, IBs, CTAs, CPOs, and APs from dealing in SFPs unless they are subject to suitability rules comparable to those of a national securities association, such as NASDR.

Under proposed Rule 2-37, members must also report to NFA within 10 days certain information, including, among other things, if the member or any of its associated persons ("APs"): (i) has been found by a self-regulatory organization to have violated any provisions of securities laws or regulations or any rule or standard of conduct of the organization; (ii) is named as a defendant in any proceeding brought by a self-regulatory organization in the securities or insurance industry; (iii) is the subject of a written customer complaint alleging theft or misappropriation of funds; or (iv) is a defendant or respondent in civil litigation or arbitration that has been disposed of by judgment, award, or settlement exceeding \$25,000 against the member or \$15,000 against an AP.

H. NFA Compliance Rule 2-9: Interpretive Notice Regarding Enhanced Supervisory Requirements

This notice requires enhanced supervisory procedures for firms that have a significant number of associates that were previously employed at firms closed down for sales practice fraud. The amendments to this notice would provide that the firm must have written supervisory procedures and must file quarterly reports showing their compliance with the supervisory requirements of the notice. If the firm trades SFPs, it must also show that its supervisory procedures ensure compliance with the applicable provisions of securities laws.

I. Interpretive Notice Regarding Obligations to Customers and Other Market Participants

This new notice will specifically prohibit certain conduct that has not been explicitly prohibited by NFA rules or interpretive notices, but is prohibited by NASDR interpretive memoranda. The notice specifically prohibits all members from trading ahead of customers. The notice also contains provisions specific to security futures activities. These include a prohibition on trading based on insider information and a requirement that communications with the public regarding SFPs be based on principles of fair dealing and good faith and provide a sound basis for evaluating the facts regarding any SFP.

J. NFA Compliance Rule 2-9: Special Supervisory Requirements for Notice Registered BDs

This new interpretive notice applies only to NFA members who are notice-registered BDs and is meant to be comparable to the detailed supervisory requirements provided for by NASDR.

Among other things, the notice provides that: (i) security futures activities must be supervised by a designated security futures principal; (ii) members must develop and implement specific written procedures concerning the supervision of security futures activities; (iii) a security futures principal must regularly review discretionary accounts and make a written record of such review; (iv) incoming and outgoing correspondence

concerning security futures activities must be reviewed and a security future principal must make a record of such review; and (v) a security futures principal must oversee reviews of branch offices and guaranteed IBs engaged in security futures activities, including an annual on-site audit.

K. NFA Compliance Rule 2-29: Use of Past or Projected Performance and Disclosing Conflicts of Interest for Security Futures Products

This new notice describes conduct that NFA considers to violate Compliance Rule 2-29 (Communications with the Public and Promotional Materials). Such conduct includes: (i) the use of outdated information in promotional materials; (ii) failing to present past performance in a balanced manner; (iii) failing to disclose all relevant costs, including commissions and fees; and (iv) unsupportable claims regarding research or other facilities.

The notice also includes information specific to SFPs, including the requirement that discussion of past performance in these products include an indication of the general market conditions during the period covered, the date of the initial trade, the price at that date, and the date and price at the end of the period.

III. Conclusion

The Division has reviewed NFA's proposals and believes that they are not inconsistent with the Act or the Commission's regulations thereunder. The Division recommends that the Commission approve the proposed amendments to NFA Bylaws 1101 and 1507; NFA Compliance Rules 1-1, 2-7, 2-8, 2-22, 2-26, 2-29, and 2-30; Section 1 of NFA's Code of Arbitration; the interpretive notice regarding enhanced supervisory requirements; and the proposed adoption of new NFA Compliance Rule 2-37 and three new interpretive notices.

Attachments