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By Overnight Mail

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Division of Trading and Markets
Commodity Futures Trading Commission
Three Lafayette Centre
1155 21st Street, N.W.
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Re: Intermediaries Study

Dear Mr. Lawton:

Thank you for meeting with NFA staff last month to discuss the intermediary study required by Section 125 of the Commodity Futures Modernization Act of 2000 (CFMA). As you know, Section 125 requires the Commission to conduct a study of the Commodity Exchange Act (Act) and the Commission's rules and orders governing the conduct of persons required to register under the Act. The purpose of the study is to determine which provisions can be replaced with core principles supplemented with interpretive guidance on acceptable practices. Section 125 also requires the Commission to solicit the views of the public, Commission registrants, registered entities, and NFA. This letter will address the issues we discussed at our meeting as well as several additional issues.

The Commission and its staff have already made great strides in adapting CFTC rules to a changing business environment, and we commend you for these efforts. In the last 2 ½ years alone, the Commission has responded to industry concerns and provided increased flexibility by, for example:

- Giving FCMs additional flexibility for calculating and reporting average prices;
- Authorizing the use of electronic signatures;
- Exempting CTAs from registration if they do not manage accounts or otherwise provide personalized trading advice;
- Raising large trader reporting levels;
- Easing the restrictions on withdrawing equity capital from an FCM;
- Enlarging the class of foreign futures and options brokers that can accept orders directly from certain U.S. customers without having to register as FCMs or IBs;

- Expanding the classes of persons who are qualified eligible persons for purposes of exemptions from CPO and CTA recordkeeping, reporting, and disclosure requirements;
- Authorizing futures self-regulatory organizations to rely on subordination agreement approvals from a broker-dealer's designated examining authority;
- Permitting CPOs to use profile disclosure documents when soliciting new participants;
- Easing the restrictions imposed on FCMs in connection with offshore funds held for foreign futures and options customers;
- Providing a simplified process for funds of funds to obtain an extension of time to file annual reports;
- Expanding the range of instruments in which FCMs and clearing organizations may invest customer funds;
- Limiting the definition of principal to those persons who are in a position to exercise control over the registrant or the registrant's futures activities;
- Eliminating the requirement that independent IBs file a certified financial statement before becoming registered;
- Replacing the detailed and administratively cumbersome ethics training rule with a general standard; and
- Providing customers and account controllers with greater choice in how they close out offsetting positions.

Even with these changes, however, there are still a number of CFTC rules that can be eliminated or amended to provide intermediaries with additional flexibility in meeting customer and business needs. Obviously, every regulation cannot be replaced with a core principle. Capital and segregation requirements, for example, must be spelled out in detail to ensure the integrity of customer funds. In other areas, however, regulations can be written to embody the same type of general standards that are involved in a core principle approach without lessening customer protection, affecting market integrity, or creating systemic risk. We encourage the Commission to replace detailed rules with general standards where this test can be met.

Before addressing specific areas, NFA wishes to reiterate its ongoing willingness to assist the Commission not only in identifying those areas that need to be addressed but also in drafting the general standards and related interpretive guidance. As we have noted in other contexts, NFA believes that the primary means of developing the interpretive guidance applicable to NFA Members should be through NFA's longstanding and successful process of obtaining industry and end user input. NFA stands ready and willing to assume the responsibility of developing guidance in all appropriate areas.

NFA's specific comments are set forth below. We have concentrated on those requirements that apply to registrants who are also NFA Members – i.e., futures commission merchants (FCMs), introducing brokers (IBs), commodity pool operators (CPOs), and commodity trading advisors (CTAs). We recognize that Commission staff is already working on a number of these issues, and we support those efforts.

THE ACT

NFA believes that the current provisions of the Act, as amended by the CFMA, provide the necessary customer protections while being flexible enough to allow intermediaries to adapt to a changing business environment. Therefore, we do not believe that the provisions of the Act regarding FCMs, IBs, CPOs, or CTAs need to be amended, nor do we see any reason for the Commission to exercise its exemptive authority under Section 4(c) of the Act for these registrants.

PART 1 – GENERAL REGULATIONS

Most of the Part 1 rules relate to capital and segregation requirements. As noted above, these requirements must be spelled out in detail to ensure the integrity of customer funds and, therefore, do not lend themselves to a core principles approach. NFA does, however, have comments on some of the specific provisions in the financial requirements. We also have comments on several Part 1 rules that do not relate to capital and segregation requirements.

Rules 1.10, 1.12, and 1.15. As you know, NFA recently adopted rules requiring NFA Member FCMs and IBs to file their financial statements electronically. However, NFA has not extended this requirement to certified financial statements since CFTC Rule 1.10(b)(2)(iii) requires those statements to be filed in hard copy. We recommend that Rule 1.10(b)(2)(iii) be amended to authorize the certified statements to be filed electronically, with an electronic certification from the independent public accountant.

Rules 1.10(b)(3), 1.10(c), and 1.10(e) require registrants to file certain financial reports, notices, and requests with both the Commission and their DSROs. NFA believes these dual filing requirements are unnecessary and burdensome to the filer. Therefore, we recommend that these rules be amended to eliminate the dual filing requirements and provide that all financial reports be filed with the DSRO. Obviously, if the Commission needs a report for any reason, the DSRO can easily provide the Commission with a copy. As explained more fully in the final section of this letter, NFA also believes that the Commission should delegate some of its responsibilities in this area to NFA.

Rules 1.10(e), 1.12, and 1.15 all require some form of immediate, written notification to the Commission and the DSRO when specified conditions are met. NFA believes that they should all be revised to provide notification only to the DSRO, who can be relied on to advise the Commission as needed. These rules should also be amended to authorize notification or confirmation by e-mail as well as telegraph and facsimile. In fact, in order to provide flexibility in dealing with ever changing technology, an even better approach is to authorize notification or confirmation by "any form of electronic communication that provides immediate notice and can be reproduced in written form."

The early warning requirements in Rule 1.12 should be eliminated. The consequence to an FCM of falling below early warning is to require it to file monthly financial statements. However, NFA recently revised its rules to require all FCM Members for which it is the DSRO to file monthly financial statements. Since this requirement was already in effect at the CBOT, CME, and NYMEX, virtually all FCMs are now required to file monthly financial statements regardless of their financial condition. Therefore, the early warning requirement is no longer needed.

Rule 1.31. As NFA has stated in the past, we fully support any efforts on the Commission's behalf to encourage greater use of information technology for recordkeeping purposes. NFA continues to believe that the best way to do this is to replace the specific technology requirements currently found in Rule 1.31 with general reliability and accessibility standards. (See the proposal NFA informally submitted to the Commission in December 1997, which is attached as Exhibit A.) NFA believes that this approach provides for greater flexibility in dealing with constantly evolving technology and eliminates the need to amend Rule 1.31 every time technology changes. Possible language for Rule 1.31 follows.

§ 1.31 Books and records; keeping and inspection.

(a) All books and records required to be kept by the Act or by these regulations shall be kept, in a form and manner acceptable to the Commission, for a period of five years. The information must be readily available during the first two years and be produced to the CFTC, upon request, at the expense of the person required to keep the books or records. All such books and records shall be open to inspection by any representative of the Commission or the U.S. Department of Justice.

(b) Persons required to keep such records shall adopt and enforce reasonable procedures to keep the books and records from being altered or destroyed.

With the speed at which technology changes, replacing the existing language of Rule 1.31 with general standards should be a priority. The level of detail in current Rule 1.31 ensures that it does not keep up with technology and denies registrants the opportunity to use the most efficient and effective record-keeping technology.

Rule 1.35. NFA recommends that Commission Rule 1.35(a)(5) be amended to provide the benefits of post-execution allocation procedures to all customers of those account managers that meet specific criteria. As noted in NFA's and FII's February 2, 2001 Report to the Commission on *Recommendations for Best Practices in Order Entry and Transmission of Exchange-Traded Futures and Options,* these criteria should specify that: a) the account manager is registered or otherwise subject to appropriate regulation;[1] b) the account manager has adopted and implemented an equitable allocation scheme that is sufficiently objective and specific to permit independent review of such procedures by the appropriate regulatory or self-regulatory authorities and the account manager's accountants; c) the account manager makes available to its customers the general structure and nature of its allocation method; and d) the account manager allocates all transactions among its customers no later than the end of the day on which the trade is made.

Bunched orders provide particular advantages to account managers and their customers. Specifically, bunched orders facilitate the prompt execution of what otherwise would be a substantial number of small orders. Moreover, by affording an account manager the opportunity to place orders for all of its customers at one time, a bunched order assists an account manager in the exercise of its fiduciary responsibility to treat all customers fairly and equally. Finally a bunched order is more likely to be executed at a single price than is a series of separate orders.[2] We do not believe that regulation should put smaller, retail customers at a disadvantage when it comes to execution quality. Therefore, NFA considers this change to be a priority.

Rule 1.55. NFA agrees with the Commission that non-institutional customers should continue to receive the disclosure set forth in Rule 1.55. However, NFA does not believe that the Commission's rule should dictate the mechanics of how disclosures are delivered or how consents are given. In fact, NFA believes that the current risk disclosure acknowledgement requirements in Regulation 1.55 are unnecessary and should be eliminated.

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[1] For example, registered CTAs that manage accounts are extensively regulated by both NFA and the Commission, and NFA reviews account allocations as part of its routine audit program.

[2] See *Recommendations for Best Practices in Order Entry and Transmission of Exchange-Traded Futures and Options*, page 25.

NFA has prosecuted a number of cases against Members who misled customers by making statements that were inconsistent with the information in the risk disclosure statement, but we cannot think of one instance where either the existence or absence of a written acknowledgement made any difference to our case. Although a few NFA audits show instances where some acknowledgements are missing, these instances tend to be recordkeeping lapses rather than actual failures to provide the risk disclosure statement. In fact, our experience is that even the less reputable firms have an incentive to provide the risk disclosure statement – with or without an acknowledgement requirement – since the fact that the risk disclosures were given can often be used as a defense against liability. Furthermore, requiring customers to sign an acknowledgement does not ensure that customers have read and understood the relevant document; as the old adage says, you can lead a horse to water but you cannot make it drink.

Rule 1.57. Rule 1.57, which was written before electronic exchanges and automated order-routing systems (AORSs), needs to be updated to respond to changes in technology. In particular, Section (a)(2) of this rule requires IBs to send customer orders to either the carrying FCM or to a floor broker, with the second option only available if the carrying FCM is a clearing member of the exchange and will be clearing the trade. As written, the rule does not allow an IB to transmit an order directly to an electronic exchange using a terminal or AORS provided by the exchange. It also does not allow an IB to transmit an order to a floor broker through an AORS provided by the exchange if the carrying FCM is not a clearing member of the exchange. On the other hand, no rule prohibits customers from bypassing both the IB and the FCM when placing these trades. We do not believe it is appropriate to impose greater restrictions on IBs than on customers.

NFA recommends that Section (a)(2) be rewritten as follows:

§ 1.57 Operations and activities of introducing brokers.

(a) Each introducing broker must –

. . . .

(2) Transmit promptly for execution all customer and option customer orders to: (i) a carrying futures commission merchant or (ii) a floor broker, executing futures commission merchant, or electronic trading system if the carrying futures commission merchant has authorized the introducing broker to transmit the orders to the floor broker, executing futures commission merchant, or electronic trading system and the

carrying futures commission merchant has systems or procedures to monitor those orders promptly after they are transmitted.

Financial and Segregation Interpretation No. 12. This interpretation should be amended to eliminate the requirement that customers sign a subordination agreement before their funds can be held off-shore. Experience has shown that the burdens imposed by this requirement outweigh the potential benefits.

PART 3 – REGISTRATION

The registration requirements are one of the fundamental protections the Act provides to public customers. In particular, registration requirements help protect customers from dealing with firms and individuals who pose a substantial risk to the public and are not accountable for their actions. With the exception of the ethics training requirement, which the Commission has already addressed, NFA believes that registration requirements must be specific and do not lend themselves to a core principles approach.

On the other hand, some provisions in the Commission's registration rules are not necessary in today's regulatory and business environment. As discussed below, these provisions can – and should – be changed. We consider all of the changes discussed in this section to be priorities.

The most effective way to streamline the Commission's registration rules is to eliminate all of its processing rules and replace them with a simple rule that provides that registrations shall be processed in accordance with rules adopted by NFA and approved by the Commission. Since the Commission no longer processes registrations, its processing rules are duplicative and unnecessary. Furthermore, Commission staff appears to believe that the Commission must change its rules before it can approve an NFA registration processing rule that is inconsistent with the Commission's processing rules. This approach delays reforms to the processing system even when NFA and the Commission agree that those reforms are appropriate in light of new technology or a changing business environment. Therefore, NFA recommends eliminating the following Commission rules: 3.10(a),(b), and (d); 3.11; 3.12(a)-(f) and (i)-(j); 3.13, 3.21, 3.22, 3.31 through 3.33; and 3.40 through 3.47.[3] This approach would also require corresponding modifications to Commission rule 3-2.

Rule 3.10. Whether or not Rule 3.10 is eliminated, NFA supports the idea of simplified registration for FCMs and IBs trading solely for institutional customers if

[3] NFA would, however, need to adopt several provisions of these rules that are not currently part of NFA's Registration Rules.

they are currently registered with another financial regulatory authority. This simplified registration process should apply to entities conducting business for institutional customers on both contract markets and designated transaction execution facilities. However, NFA continues to question the need for duplicative background checks for securities registrants, including general securities representatives, even if they deal with retail customers.

Furthermore, NFA believes that the registration process should be streamlined for all registrants by amending Form 8-R to eliminate the questions regarding employment, residential, and educational background. Currently, individuals must list their employers, dates of employment, and periods of unemployment, military service, and schooling for the ten years preceding the application. They must also provide their residential addresses for the last five years. Additionally, sponsors must contact all employers for the past three years and document those contacts. None of this information relates to or is used by NFA to determine an applicant's fitness for registration. The only non-disciplinary information that may relate to fitness is registration history, and NFA has that information in its databases. Employers who wish to collect and verify past employment and education history are free to do so, but including that information in the information collected by NFA and requiring employers to verify past employment adds nothing to the registration process.

PART 4 – COMMODITY POOL OPERATORS AND COMMODITY TRADING ADVISORS

The Commission has been responsive to many of the concerns expressed by CPOs and CTAs over the years. Nonetheless, there are a number of areas where the Commission's rules could be further revised to meet the business needs of the managed funds industry without lessening customer protection.

Rules 4.13 and 4.14. NFA continues to urge the Commission to adopt an exemption from registration for CPOs who operate collective investment vehicles that do only a *de minimis* amount of futures transactions and for CTAs who provide their trading advice solely to these vehicles and to collective investment vehicles described in Rule 4.5. A copy of NFA's petition for rulemaking, dated July 13, 1999, is attached as Exhibit B.

Rules 4.21 and 4.31. NFA recommends that the timing requirements for disclosure documents be revised to make them consistent with the requirements imposed on FCMs and IBs. In particular, NFA urges the Commission to delete the requirement that a CPO or CTA provide a disclosure document to a prospective pool participant or client prior to soliciting that person. A CPO would still be required to provide a disclosure document to a participant prior to accepting or receiving funds from

the participant, and a CTA would still be required to provide a disclosure document to a client prior to entering into an agreement with the client to direct or guide the client's account.

We recognize that the Commission recently amended its rules to allow CPOs to use a profile disclosure document for solicitation purposes, and that action was a significant step forward. However, eliminating the requirement that some type of disclosure document be provided before a prospective participant or client is solicited will give CPOs and CTAs more flexibility to determine interest before providing these documents. All solicitations would, of course, be subject to NFA Compliance Rule 2-29, and solicitations for public pools would be subject to the relevant securities laws and regulations. Advertisements would also be subject to CFTC Rule 4.41.

If the Commission is not willing to eliminate the restrictions on advertising prior to delivery of a disclosure document, the Commission should at least authorize CPOs and CTAs to use tombstone advertisements similar to those authorized by SEC Rule 134.

Rules 4.23 and 4.33. NFA recommends revising these rules to eliminate the requirement that a CPO or CTA maintain its records at its main business office. This is not always the most convenient location for the CPO or CTA, especially if an accountant or other third party creates the records.

Obviously, a CPO's or CTA's records must be assessible to the Commission and NFA for auditing and investigative purposes. However, there are other ways of meeting this need. For example, if the records are held by a third party, the rule could require the CPO or CTA to enter into an agreement with the third party to provide access to the records or require the CPO or CTA to provide the records within 72 hours, as is currently the case for records held at a main business office outside the United States.

Rule 4.35(a)(6). The Commission should adopt its proposed rules requiring CTA performance to be calculated using the amount committed to trading as the denominator. As we have stated in numerous filings over the years, this method will enhance customer protection by ensuring that rate-of-return figures measure the CTA's performance rather than its clients' differing cash management strategies and by reducing CTAs' ability to overstate positive returns.

Rules 4.2 and 4.21. There are also two technical matters that the Commission should address. First, Rule 4.2 should be amended to include notices of eligibility for exemptions under Rules 4.5, 4.6, 4.7, 4.12, 4.13, and 4.14 among the documents that can be filed electronically. Second, Rule 4.21 should be amended to

codify Commission no-action relief for CPOs who operate both a master fund and a feeder fund to relieve the CPO from its obligation to provide the master fund's disclosure document to the feeder fund.

PART 30 – FOREIGN FUTURES AND FOREIGN OPTIONS TRANSACTIONS

As detailed at the beginning of this letter, in the last two or three years the Commission has made significant changes to the Part 30 rules and has modified or issued interpretive guidance on those rules to ensure that they continue to provide appropriate customer protection while eliminating unnecessary burdens on, and competitive disadvantages to, Commission registrants. Therefore, NFA only has one suggestion regarding these rules.

Rule 30.8. NFA recommends that Rule 30.8 be eliminated. Rule 30.8 was adopted when the Commission began regulating foreign futures transactions and authorized foreign options transactions. In the more than a decade since, NFA has not found a good use for the information reported under that rule, yet we are still required to collect it and maintain it. While this is not one of NFA's top priorities, it is a burdensome requirement that is easy to correct merely by eliminating it.

PART 155 – TRADING STANDARDS

Rules 155.3 and 155.4 have proven to be effective means of ensuring that FCMs, IBs, and their employees put their customers' interests ahead of their own. Moreover, NFA does not believe that these rules have been overly burdensome, and we do not see a particular need to replace them with more general requirements.

Although we do not see a need to replace Rules 155.3 and 155.4 with a less detailed rule, there is one requirement in those rules that we believe imposes an unnecessary burden on registrants. Rule 155.3(c)(3) and (d)(2) and Rule 155.4(c)(2) require copies of all statements and order tickets to be sent to an individual's employer if the individual is employed by another FCM or IB. We agree that the employer should receive copies of the account statements so that it can check to see if the employee is trading ahead of customer orders or engaging in other dubious conduct. We also believe that the employer should be able to obtain copies of the order tickets upon request. We do not, however, see a need to routinely provide copies of order tickets to the employer, and we suggest that requirement be deleted from the rules.

OTHER

As technology plays an ever increasing role in the futures industry and the industry moves towards straight-through processing, the protocol used to transmit order

data and the type of data that is submitted become increasingly important. NFA has been an active member of the CFTC Technology Advisory Committee's Subcommittee on Standardization, which recently issued a report entitled *Recommendations for Standardization of Protocol and Content of Order Flow Data*. The Commission should implement the recommendations in the Subcommittee's Report in order to increase efficiencies in processing and regulation. In particular, the Commission should require all protocols used for transmitting order information to include certain standardized data components identified in the Report, issue best practice guidance to encourage the industry to use a standardized protocol, and adopt the Report's recommendations on implementation dates and industry support.

On January 22, 1999, NFA submitted proposed amendments to NFA Registration Rule 214 to add a new section (d) and provide intermediaries with qualified immunity for statements they make on Form 8-T. This proposal is designed to alleviate intermediaries' reluctance to make complete disclosures on a Form 8-T because of the potential for defamation lawsuits. Neither the public nor future employers are well-served when a firm has to weigh its potential liability for defamation against the need to provide full and accurate information regarding an employee who has engaged in conduct detrimental to customers or the futures markets. Therefore, the Commission should approve the proposed amendments to Registration Rule 214.

AREAS TO DELEGATE TO NFA

As always, NFA stands ready to assume additional responsibilities delegated by the Commission. Over the years, we have clearly demonstrated our qualifications to perform these duties, with registration and disclosure document review as prime examples of successful delegations.

NFA recommends that the Commission delegate to NFA the authority to approve changes in fiscal year-end under Rule 1.10(e) and to grant extensions for financial filings by FCMs and IBs under Rules 1.10(f) and 1.16(f). NFA also recommends that the Commission delegate to NFA the authority to grant extensions for CPO annual reports under Rule 4.22(f)(1).

NFA is also ready and willing to assume administrative responsibilities for the Commission's reparations program. NFA has been advocating for years that the reparations program be eliminated. NFA believes that the program is unnecessary given the availability and success of NFA's arbitration and mediation programs, which are completely funded by the industry and users of the programs. NFA understands, however, that the Commission believes that the Act requires it to maintain a reparations program. Therefore, as an alternative to eliminating the program, NFA recommends that the Commission turn over the administration of the reparations program to NFA.

Under this delegation, reparations proceedings could continue to be governed by the Commission's Part 12 rules and decided by Commission Administrative Law Judges and Hearing Officers, but the Commission would not need to maintain its own staff to administer the forum. The infrastructure NFA has developed for its own dispute resolution programs can easily be adapted to administer the reparations program in a timely and cost-effective manner.

NFA encourages the Commission to delegate these responsibilities to NFA. We also welcome any other responsibilities the Commission chooses to delegate to us.

CONCLUSION

NFA appreciates the opportunity to provide input on this important study. NFA staff is available to more fully discuss any of the issues raised in this letter or any other issues raised by the industry or identified by Commission staff, and we look forward to a close working relationship with the Commission as it conducts the study.

Sincerely,

Thomas W. Sexton
Vice President and General Counsel
National Futures Association

Enclosures

(kpc/Comment Letters/Intermediaries Study)