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NFA NATIONAL FUTURES ASSOCIATION
200 W. MADISON ST. • CHICAGO, IL • 60606-3447 • (312) 781-1300

April 25, 2002

By Overnight Mail

COMMENT

Ms. Jean A. Webb
Secretary of the Commission
Commodity Futures Trading Commission
Three Lafayette Centre
1155 21st Street, NW
Washington, D.C. 20581

Re: Request of the National Futures Association for Approval of Interpretive Notice to NFA Compliance Rule 2-9: Supervision of the Use of Automated Order-Routing Systems (67 *Fed. Reg.* 14701 (Mar. 27, 2002))

Dear Ms. Webb:

Automated order-routing systems (AORSs) are becoming more and more common and are gradually replacing personal telephone contact as a means of entering orders for futures contracts. Although these simply provide different ways to enter an order and are governed by longstanding regulatory standards, the technology that is used affects the manner in which firms comply with those standards. As AORSs become more prevelant, it becomes increasingly important for NFA Members to understand how to adopt controls that apply pre-existing regulatory standards to these systems.

AORSs provide a valuable service to customers and can improve execution time and quality. However, they can also increase the possibility that a customer's order information will be altered or appropriated without the customer's permission, that a customer's order will be lost in the pipeline if the system becomes overloaded, or that a customer will enter trades that the firm has not authorized the customer to make. As the General Accounting Office has noted:

> With proper controls, AORS used to transmit customer orders can further regulatory objectives by enhancing customer protection, market integrity, and financial integrity, as well as provide other benefits to futures market participants. However, without proper controls, such AORS can raise customer protection and other regulatory concerns related to inadequate system capacity and security and increased opportunities for unauthorized trading.[1]

[1] General Accounting Office, Commodity Exchange Act: Issues Related to the Regulation of Electronic Trading Systems, pgs. 12-13 (May 2000).

NFA's proposed interpretive notice on AORSs is designed to provide Members with guidance on their supervisory responsibility to include appropriate controls in the AORSs they offer to their customers. The interpretive notice was the culmination of a long process that included a wide-ranging review of AORS standards and regulatory requirements and sought and incorporated substantial input from all segments of the futures industry.

The interpretive notice adopted by NFA's Board of Directors recognizes that Members have a supervisory responsibility to process orders in a reliable and timely manner and to impose credit and risk-management controls on trading done by any particular customer. The notice also recognizes that supervisory standards do not change with the medium used but that how those standards are applied may be affected by technology. Therefore, the interpretive notice embraces a flexible approach to AORSs that provides meaningful guidance to Members without mandating specific technology.

This comment letter begins by describing the comprehensive process that NFA went through in developing the interpretive notice. It then describes the comments received by NFA as a result of its request for membership comment and the resulting changes to the notice. Finally, it discusses NFA's reasons for adopting the interpretive notice in its current form.

The Process

In November 2000 the Board of Directors – responding to a letter from then CFTC Chairman Rainer – asked NFA's Special Committee to Review Technology to develop standards relating to security, capacity, and controls for automated order-routing systems (AORSs) that route orders through an FCM. The Board also directed the Special Committee to find a middle ground between one-size-fits-all requirements that mandate specific technology and guidelines that are so general as to be meaningless.

The Special Committee was composed of representatives from six FCMs (ranging from large broker-dealer/FCMs to a smaller, futures-only firm), six exchanges, two end users (CPO/CTAs), two third-party vendors, and one clearing organization. This broad range of viewpoints was a tremendous asset to the Special Committee in developing the interpretive guidance, and the proposed interpretive notice represents the consensus view of these diverse individuals. A list of the Special Committee members is attached as Exhibit A.

The Special Committee met eight times between November 14, 2000 and December 11, 2001. During that time, it reviewed approximately twenty studies, proposals, advisories, and similar documents issued by eight separate organizations,

(including the SEC, the CFTC, the GAO, and IOSCO); sought input from NFA's FCM, IB, and CPO/CTA Advisory Committees and from the Futures Industry Association (FIA), the Managed Funds Association (MFA), and the National Introducing Brokers Association (NIBA); and published the proposed interpretive notice for membership comment. The interpretive notice went through seven drafts, including several major revisions based on comments received from the industry at different points during the process.

The Special Committee's initial draft of the interpretive notice affirmed the basic supervisory standards that apply to all order-routing processes regardless of the medium used. The draft then described the best practices used in the industry for orders routed through AORSs and stated that using those practices would provide Members with a safe harbor for meeting the basic standards. When the draft was circulated, some members of FIA's Law and Compliance Division objected to the best practices/safe harbor approach. In particular, the Law and Compliance members felt that best practices should be developed by industry organizations rather than regulators. They were also concerned that characterizing elements of the draft notice as "best practices" or a "safe harbor" could lead to unintended uses by third parties in civil litigation. Finally, they objected to the level of detail contained in the draft interpretive notice.

As a result of these concerns, the Special Committee redrafted the notice without the references to best practices and safe harbors and with less detail. The Special Committee then sought comments on the revised draft from FIA, MFA, NIBA, and NFA's FCM, IB, and CPO/CTA Advisory Committees.

NIBA was the only industry trade association to file comments with the Special Committee, although representatives of FIA did participate in the FCM Advisory Committee's discussion. A copy of NIBA's Comment Letter is attached as Exhibit B. NIBA generally supported the interpretive notice, as did the IB and CPO/CTA Advisory Committees. The FCM Advisory Committee, on the other hand, was concerned that NFA might be establishing standards that would be costly to comply with and could be used against Members in litigation. They felt that NFA was getting ahead of the curve and should take a more cautious approach. In fact, the FCM Advisory Committee questioned whether NFA should be doing anything at all in this area. A copy of a memorandum to the Special Committee describing the Advisory Committees' comments is attached as Exhibit C.

After considering these comments, the Special Committee revised the interpretive notice to eliminate more of the details regarding technology and – at the direction of NFA's Executive Committee – put the revised notice out for membership comment. Notice to Members I-01-15, issued August 31, 2001, is attached as Exhibit D. Although comments were originally due on September 28, 2001, that deadline was

subsequently extended to November 15, 2001. The Special Committee also again asked NFA's Advisory Committees to review and comment on the revised language. The comments NFA received are described in the next section of this letter.

After the comment period closed, the Special Committee reviewed the comments received and made additional changes to the interpretive notice. The revised notice was then sent to the Executive Committee and the Board of Directors. This final version of the notice was adopted by the Board on February 21, 2002 and submitted to the CFTC on March 1, 2002.

Summary of the Comments and the Resulting Changes

NFA received nine comment letters in response to its request for membership comment. The FCM, IB, and CPO/CTA Advisory Committees also provided comments. Copies of the comments are attached as Exhibit E. In general:

- All of the commenters except the FCM Advisory Committee supported NFA's efforts to provide guidance to Members on their supervisory responsibilities for orders entered through an automated order-routing system (AORS);

- Several of the commenters questioned the specific approach taken by the proposed interpretive notice, which they characterized as being overly prescriptive rather than simply providing guidance; and

- Some commenters believed that NFA should not mandate that the supervisory procedures be in writing. Some commenters also felt that it is unnecessary to have procedures covering protections that are already written into an automated system.

In contrast to the other commenters, the FCM Advisory Committee did not believe that NFA should issue any interpretive guidance on the use of AORSs. According to the FCM Advisory Committee:

- Members already have all the guidance they need so the notice is unnecessary;

- The notice imposes obligations that are not present for orders entered over the telephone; and

- Decisions regarding AORSs should be a matter of business judgment, not regulation. The members of the FCM Advisory Committee believe that the guidance issued in the securities industry does not impose the same regulatory obligations on firms, and they do not believe that NFA should be a leader in this area.

As discussed below, the Special Committee did not agree that the interpretive notice was unnecessary or that the general approach was too prescriptive. It did, however, agree with a number of the specific comments that were made and revised the interpretive notice accordingly. In particular, the Special Committee:

- Added language to the introduction stating that certain of the procedures in the notice may not be needed when only firm personnel can enter orders into the system;

- Clarified that encryption and firewalls can be replaced with more appropriate and effective security procedures as they are developed or identified;

- Eliminated a statement that Members should periodically check with each customer to verify that the individuals who are authorized to access the AORS are still authorized to do so and to discover whether any passwords should be disabled, replacing it with a statement that Members should, as appropriate, provide customers with a means to notify the Member when individuals are no longer authorized or passwords should be disabled;

- Clarified that the term "customer" includes CTAs except when referring to credit-worthiness and ability to accept risk;

- Revised two sections of the notice to allow Members to use any appropriate means for conducting periodic security testing and capacity reviews;

- Revised the section on administration to clarify that the responsibility for the security of the AORS lies with the firm and not a single individual;

- Revised the section on disaster recovery and redundancies to note that backup systems can include facilities for accepting orders by telephone or reliance on third-party brokers or clearing firms;

- Added a footnote stating that pre-execution controls do not have to be built into a system that will only be used by customers subject to post-execution controls;

- Eliminated a separate section on "fat-finger" protections and replaced it with a footnote stating that fat-finger protections are part of pre-execution controls;

- Clarified that the ability to monitor trades post-execution can be provided by either the AORS or other risk-management systems; and

- Added a footnote to clarify that the written procedures do not have to contain technical specifications or duplicate procedures that are documented elsewhere.

Discussion

The Special Committee and the Board believe that the industry needs guidance and it is appropriate for NFA to issue it. The Special Committee and the Board also believe that the standards must be clear enough to provide meaningful guidance to Members and to ensure that firms can be audited for compliance. The interpretive notice provides that guidance by clarifying existing requirements.

After some introductory language, the interpretive notice contains three sections that deal with security, capacity, and credit and risk-management controls. Each section of the interpretive notice begins with a general standard that applies to all orders regardless of the manner of entry. Although these general standards have not been explicitly spelled out in earlier guidance issued by NFA, they are nothing new. They are intuitive standards that are – and have always been – implicit in NFA Compliance Rule 2-9.

Each of the three sections then goes on to give more practical guidance on how the general standard applies to orders entered through an AORS. This guidance does not impose new requirements but merely clarifies how existing requirements apply to those orders. For example, the section on security states that the AORS should authenticate the user and goes on to give some examples of possible authentication methods. Although the authentication methods that are listed are specific to electronic systems, the duty to authenticate the user has always existed – it goes without saying that a Member should not accept a telephone order without reason to believe that the person placing the order is who he says he is.

The FCM Advisory Committee commented that decisions regarding AORSs should be a matter of business judgment, not regulation. The Special Committee and the Board are mindful of this concern and do not mean to substitute their business judgment for that of individual Members. The interpretive notice provides Members with flexibility to design procedures tailored to their own circumstances and to take advantage of changes in technology. On the other hand, the Special Committee and the Board believe that the use of AORSs is an appropriate area for regulatory guidance and that the requirements in the interpretive notice are necessary to protect customers and other users of the futures markets.

The requirements in the interpretive notice were carefully crafted to ensure that they do not impose unnecessary burdens on Members. In fact, the Special Committee was very responsive to concerns from smaller entities. For example, NFA

received several comments that it would be too expensive for small entities to either maintain an independent internal audit department or hire a qualified outside party to test the system. As a result, the interpretive notice was revised to allow these firms to use "other appropriate means" for conducting periodic security testing and capacity reviews.

Some of the comments stated that the interpretive notice is too specific. The Special Committee addressed these concerns where appropriate, and each draft of the interpretive notice became less detailed and more generic. However, the Special Committee believes that making it any more generic than it currently is would make it so general as to be meaningless, and the Board agrees with this assessment.

The FCM Advisory Committee also commented that the guidance issued in the securities industry does not impose these regulatory obligations on securities firms, and the FCM Advisory Committee did not believe that NFA should be a leader in this area. The Special Committee and the Board do not agree. NFA would not be a responsible regulator if it waited to address a need until someone else addressed it first or until a crisis occurred. The Special Committee and the Board believe that a need exists and that NFA should address that need.

As a practical matter, NFA's interpretive notice does not contain anything new. In regard to system security, the banking regulators impose similar requirements,[2] and the CFTC recently adopted Regulation 160.30, which, while less detailed, applies the same general standard.[3] In regard to capacity, the provisions in the interpretive notice were generally modeled after several SEC releases.[4] Although NFA may be the

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[2] *See, e.g.*, FFIEC Guidance on Authentication, SR 01-20 (Federal Reserve, Aug. 15, 2001); Interagency Guidelines Establishing Standards for Safeguarding Customer Information and Recision of Year 2000 Standards for Safety and Soundness, 66 *Fed. Reg.* 8615 (Feb. 1, 2001) (not medium-specific); Uniform Rating System for Information Technology, 64 *Fed. Reg.* 3109 (Jan. 20, 1999); Technology Risk Management, OCC 98-3 (OCC, 1998); Assessment of Information Technology in the Risk-Focused Frameworks for the Supervision of Community Banks and Large Complex Banking Organizations, SR 98-9 (Federal Reserve, Apr. 20, 1998).

[3] Privacy of Consumer Financial Information, 66 *Fed. Reg.* 21235 (Apr. 27, 2001). The SEC has adopted similar regulations. Privacy of Consumer Financial Information, Regulation S-P, 65 *Fed. Reg.* 40333 (June 29, 2000).

[4] Policy Statement: Automated Systems of Self-Regulatory Organizations (II) (SEC, May 9, 1991); Policy Statement: Automated Systems of Self-Regulatory Organizations (SEC, Nov. 16, 1989); Staff Legal Bulletin No. 8 (SEC, Sept. 9, 1998) (discussing capacity requirements for broker-dealers and stating in fn. 10 that broker-dealers should use the two automation policies as guidelines). Although the automation policies state that they are guidance to be adopted on a voluntary basis, the SEC appears to have applied those policies as requirements for the development of new systems. *See, e.g.*, Order Approving Proposed Rule Change by the Pacific Exchange, Inc., as Amended, and Notice of Filing and Order Granting Accelerated Approval to Amendment Nos. 4 and 5 Concerning the Establishment of the

first regulator to issue guidance on applying credit and risk-management controls to AORSs, the obligation to guard against systemic risk is as old as the CFTC – or perhaps as old as the markets themselves.

NFA did not write the interpretive notice in a vacuum. The members of the Special Committee came from divergent segments of the futures industry; the Special Committee specifically sought input from the three trade associations that represent futures intermediaries and from NFA's Advisory Committees, which represent those same constituencies; and NFA put the interpretive notice out for Member comment. The Special Committee considered all of the comments it received from these groups and made a number of significant changes to the interpretive notice in response to those comments. The Special Committee could not, however, please everyone and still remain faithful to NFA's responsibilities as a regulator.

The *Federal Register* release states that "NFA has also revised the required annual self-examination to include the WebTrust$^{SM/TM}$ Self-Assessment Questionnaire. . . ." Although this statement is true, NFA would like to clarify the effect of incorporating that document into NFA's self-examination requirement. NFA's interpretive notice on Compliance Rule 2-9: Self-Audit Questionnaires (NFA Manual, ¶ 9020) requires NFA Members to annually review their operations using a questionnaire developed by NFA and to attest in writing that the Member has reviewed its current procedures and they appear to be adequate to meet the Member's supervisory responsibilities. The Member does not have to actually fill out the self-examination questionnarie, nor is it required to keep any documentation other than the written attestation. Furthermore, the Member does not have to review any sections of the questionnaire that do not apply to the Member's business. Therefore, incorporating the WebTrust$^{SM/TM}$ Self-Assessment Questionnaire into the self-examination does not require Members to actually fill out the questionnaire or to review any portions of it that are not applicable to the Member's business.[5]

As noted above, the interpretive notice does not impose new requirements but merely clarifies existing ones. Nonetheless, NFA realizes that some Members may not have understood these requirements and may not currently comply with them. We will work with Members to bring them into compliance and will not take disciplinary action against any Member that comes into compliance within a reasonable time.

Archipelago Exchange as the Equities Trading Facility of PCX Equities, Inc., 66 *Fed. Reg.* 55225, 55230 (Nov. 1, 2001) ("The PCX would also be required to comply with the Commission's Automation Review Policy....").

[5] Some of the questions in the WebTrust$^{SM/TM}$ Self-Assessment Questionnaire go beyond the standards described in the interpretive notice on AORSs. Those questions may be useful to Members in evaluating their procedures for supervising AORSs, but they are not intended to impose any additional requirements.

NFA also recognizes that some Members have outstanding agreements with third-party vendors that may not comply with the standards in the interpretive notice. NFA does not expect Members to breach their existing agreements. NFA does, however, expect Members to work with their third-party vendors to conform to those standards. Members should also avoid entering into subsequent agreements that do not comply.

NFA has worked closely with the industry throughout this entire process and will continue to do so. We will be happy to answer any questions and respond to any concerns that are raised by the comment letters.

If you have any questions or need any additional information, please contact Kathryn Camp, Associate General Counsel. She can be reached by telephone at 312-781-1393 or by e-mail at kcamp@nfa.futures.org.

Very truly yours,

Thomas W. Sexton
Vice President and General Counsel

Attachments

cc: Chairman James E. Newsome
Commissioner Barbara Pedersen Holum
Commissioner Thomas J. Erickson
Lawrence B. Patent, Esq.
Christopher W. Cummings, Esq.

(kpc/order-routing/CFTC Comment Letter)

EXHIBIT A

SPECIAL COMMITTEE TO REVIEW TECHNOLOGY

Members

Thomas F. Basso
Chief Executive Officer
Trendstadt Capital Management, Inc.

David M. Battan
Vice President and General Counsel
Interactive Brokers, LLC

John P. Davidson
Managing Director of Equity Operations
Morgan Stanley & Co., Inc.

Clarence Delbridge, III
Executive Vice President
FC Stone, LLC

Patrick Gambaro
Executive Vice President
Board of Trade of the City of New York, Inc.

Douglas B. Gardner*
Director
Cantor Financial Futures Exchange

Thomas J. Hammond
Executive Vice President, Clearing Services
Board of Trade Clearing Corporation

Richard Jaycobs
Chief Executive Officer
OnExchange

Kevin Kometer
Director, Advanced Technologies
Chicago Mercantile Exchange

* Deceased, September 11, 2001

Thomas McCabe
Vice President of Exchange Operations
Chicago Board of Trade

William P. Miller
Senior Vice President and Independent Risk Oversight Officer
Commonfund Asset Management Company, Inc.

Steve Monieson
Vice President
Trading Technologies

John Munro
Senior Vice President, Regulation and Compliance
Rolfe & Nolan

Ronald S. Oppenheimer
First Vice President and General Counsel, Futures and Options
Merrill Lynch & Co.

Brian Regan
Associate General Counsel
New York Mercantile Exchange

Michael R. Schaefer
Executive Vice President
Salomon, Smith Barney, Inc.

William M. Sexton
Chief Operating Officer
Refco, Inc.

(kpc/order-routing/Exhibit A)

NIBA
THE NATIONAL INTRODUCING BROKERS ASSOCIATION
55 WEST MONROE, SUITE 3330, CHICAGO, IL 60603
PHONE 312•977•0598 FAX 312•977•0733

EXHIBIT B

Thursday, June 21, 2001

Kathryn Page Camp, Associate General Counsel
National Futures Association
200 West Madison Street, Ste. 1600
Chicago, IL 60606-3447

RE: Comments on Interpretive Notice: Supervision of Use of Automated Order-Routing Systems

Dear Ms. Camp:

Thank you for the opportunity to comment on the above referenced proposed National Futures Association (NFA) Interpretive Notice.

The National Introducing Brokers Association (NIBA) membership consists largely of IBs. A primary concern to the NIBA membership is the cost associated with implementing security, capacity standards and procedures and credit and risk-management controls which are suggested by the Interpretative Notice. The costs incurred by the FCM will be passed through to the IB.

As the NFA is aware, the use of automated order-routing systems (AORSs) by Introducing Brokers (IBs) will largely be mandated by each IB's clearing firm. Our Futures Commission Merchants (FCMs) will decide on the type and method of AORSs which will be in use throughout their network of brokers and offices. Consequently, FCMs will be responsible for, and in control of the technology and issues surrounding the use of that technology.

With that in mind, we have based the following comments on conversations with both our IB members and FCM sponsors.

1. The Interpretative Notice is well thought out by NFA staff and proposes solutions which will help assure the integrity and confidentiality of orders and account information at all points during the order-routing process.

2. As a general comment: Because FCMs vary in the size and complexity of their operations, any rules governing AORSs and the enforcement of those rules, will have to be general in nature and enforced with a certain amount of flexibility. The NFA's focus should not be on micro-managing the FCM's precise style of doing business, but on allowing each FCM to transact business in the manner best suited to its structure within the standards set by the NFA.

3. While most FCMs currently employ systems which are compliant with all the standards and performance levels proposed, there may be some which do not. Even firms which substantially comply, may have problems in expensive and exacting areas such as encryption. Will those FCMs be given a grace period in which to bring their systems into compliance with NFA standards or guidelines as outlined in the Interpretative Notice, and what happens to their customers and IB network if the firm cannot comply?

4. Those customers exempted from pre- or post-execution controls due to "sophistication, credit-worthiness" or other conditions should be required to have a written explanation for the exemption and approval by a supervisor on file and available for NFA inspection.

Thank you for requesting our comments on this NFA Interpretive Notice. Please contact the Association at the above address or by e-mail at melinda@futuresrep.com to discuss these issues further.

Sincerely,

Melinda Schramm, Chairman

The National Introducing Brokers Association
By Its Board of Directors

EXHIBIT C

June 25, 2001

Memo To: Special Committee on Technology

From: Kathryn Page Camp

Re: Advisory Committee Comments on Interpretive Notice

All three of NFA's Advisory Committees reviewed the June 8, 2001 draft of the interpretive notice on the supervision of automated order-routing systems. Their comments are summarized below.

The FCM Advisory Committee had three comments regarding the content of the interpretive notice. First, as a general matter, they felt that the notice was too specific. Second, they felt that the notice did not clearly state that Members do not have control over direct access systems and systems chosen by the customer. They also believe that Members do not have control over, and should not be responsible for, any system provided by an independent service provider under a standard contract. Third, they did not like the word "integrity" in the first paragraph of the introduction and the first paragraph in the section on security.

On a more basic level, the FCM Advisory Committee was concerned that NFA might be establishing standards that would be costly to comply with and could be used against Members in litigation. They believe that NFA is getting ahead of the curve and should take a more cautious approach. In fact, the FCM Advisory Committee questioned whether NFA should be doing anything at all in this area.

The CPO/CTA Advisory Committee supports the interpretive notice. They do, however, suggest that the notice should explicitly state that a Member should consider more than just credit when deciding whether to authorize a customer to use a direct access system. Some members of the Committee also felt that NFA should do as much as possible to encourage Members to use pre-execution controls rather than post-execution monitoring.

The IB Advisory Committee generally supports the interpretive notice. They had four comments on the content of the notice. First, they suggested that the fourth paragraph of the introduction be re-written to make it clear that IBs do not normally have control over FCM systems used by IBs' customers and that IBs are not responsible for those systems. Some IBs do, however, develop and provide their own systems, and the IB Advisory Committee fully agrees that an IB should be responsible

for its own system. Second, the IB Advisory Committee felt that it is impractical to require capacity levels "several times" in excess of the peak volume on an average day given that most contracts do not require service providers to add another server until the existing servers reach 70% of capacity. Third, they believe that many of the existing systems, including some widely used systems, do not use encryption, and they felt that requiring encryption was impractical. Fourth, the IB Advisory Committee does not believe that the retail v. institutional distinction should drive performance levels and the type of controls (pre-execution vs. post-execution) imposed, as the interpretive notice suggests. They believe that retail customers expect the same level of service as institutional customers, and they pointed out that historically it has been institutional customers – not retail customers – who have created financial problems for firms.

(kpc/OrderRouting/Special Committee-4)

EXHIBIT D

Notice to Members

National Futures Association
Notice I-01-15

Request for Comments on Proposed Interpretive Notice Regarding Automated Order-Routing Systems

The Board of Directors has asked the Special Committee to Review Technology to develop standards relating to security, capacity, and controls for automated order-routing systems (AORSs) that route orders through an FCM. The Board also directed the Special Committee to find a middle ground between one-size-fits-all requirements that mandate specific technology and guidelines that are so general as to be meaningless. After studying the issue, the Special Committee determined that the best way to address AORS issues is through interpretive guidance to Members on their supervisory responsibilities over orders entered through those systems.

The Special Committee is composed of representatives from all areas of the industry involved in order-routing, including FCMs, exchanges, end users, and third party vendors. The Committee also sought input from industry trade organizations and NFA's FCM, IB, and CPO/CTA Advisory Committees. The resulting broad range of viewpoints has been a tremendous asset to the Special Committee in drafting the interpretive notice. The Committee drew on the experience of other industries – particularly the securities industry – by reviewing releases, studies, standards, and reports issued by the Securities and Exchange Commission, the General Accounting Office, the International Organization of Securities Commissions, and AICPA/CICA, among others.[1]

The use of, and standards for, AORSs is an important issue that has generated healthy discussion from divergent viewpoints. Therefore, the Executive Committee has asked the Special Committee to publish the draft interpretive notice for comment.

Summary of the Interpretive Notice

The attached draft interpretive notice recognizes that Members have a supervisory responsibility to process orders in a reliable and timely manner and to impose credit and risk-management controls on trading done by any particular

[1] AICPA/CICA is the American Institute of Certified Public Accountants and the Canadian Institute of Chartered Accountants.

customer. The notice also recognizes that supervisory standards do not change with the medium used but that how those standards are applied may be affected by technology. Therefore, as the Board directed, the notice tries to achieve a middle ground between one-size-fits-all requirements that mandate specific technology and guidelines that are so general as to be meaningless.

The notice requires Members to have supervisory procedures but does not specify what those procedures must be, thereby providing each Member with the flexibility to design procedures that are tailored to the Member's own situation. The Special Committee also recognizes that not even the best procedures can prevent every breach of security, ensure that the system never becomes overloaded, or eliminate every financial risk to the firm or its other customers. Therefore, the notice only requires Members to adopt procedures reasonably designed to accomplish these ends.

Regarding security, the draft interpretive notice states that Members who accept orders must adopt and enforce written procedures reasonably designed to protect the reliability and confidentiality of orders and account information at all points during the order-routing process. To that end, the notice states that Members should have procedures addressing authentication of users, encryption of information, firewalls, authorization of users, periodic testing of the AORS's security systems, and who will administer system security.

On the subject of capacity, the draft interpretive notice provides that Members who accept orders must adopt and enforce written procedures reasonably designed to maintain adequate personnel and facilities for the timely and efficient delivery of customer orders and reporting of executions. In this regard, the procedures should cover capacity reviews, disaster recovery and redundancies, and advance disclosure to customers of both potential systems problems and alternative procedures for customers to use if problems occur.

In connection with credit and risk-management controls, the draft interpretive notice states that Members who accept orders must adopt and enforce written procedures reasonably designed to prevent customers from entering into trades that create undue financial risks for the Member or the Member's other customers. In particular, the procedures should address pre-execution and post-execution controls and how to determine which controls apply to a particular customer, fat-finger protections, special considerations for authorizing use of direct access systems, and on-going review of the controls imposed.

Request for Comment

The Special Committee welcomes comments on all aspects of the draft interpretive notice. The Committee specifically requests comments on the following.

1. Does an NFA Member have a supervisory responsibility over orders entered through an AORS that is within the Member's control? Are there existing standards of sufficient clarity to inform Members what is expected of them when supervising these orders? If so, please identify those standards.

2. Has the Special Committee taken the right approach by drafting an interpretive notice on Members' supervisory responsibilities? Should NFA adopt a rule instead?

3. As written, the draft interpretive notice specifies particular matters that Members should address in their supervisory procedures while providing Members with flexibility in how they address those matters. Should the interpretive notice go farther and identify best practices used in the industry? If so, should it provide a safe harbor for Members who use the best practices listed in the notice?

4. Does the interpretive notice contain the right amount of detail? Is it too specific? Not specific enough?

5. As written, the draft interpretive notice applies to any AORS the Member has control over. One of the issues the Special Committee struggled with is when a Member has control over an AORS. The Committee requests comments on when an AORS is within a Member's control, including examples and factors to consider.

6. Is the description of the available technology accurate? Would any of the technological functions mentioned in the interpretive notice be too costly? Ineffective? Are there other functions that should be included?

Comments should be sent to Kathryn Camp, Associate General Counsel, and should be received by September 28, 2001. Comments can be filed by e-mail at kcamp@nfa.futures.org, by facsimile at 312-781-1523, or by mail at National Futures Association, 200 West Madison St., Suite 1600, Chicago, Illinois 60606. Questions can be directed to Kathryn at the above e-mail address or by telephone at 312-781-1393.

COMPLIANCE RULE 2-9: SUPERVISION OF THE USE OF AUTOMATED ORDER-ROUTING SYSTEMS

INTERPRETIVE NOTICE

NFA Compliance Rule 2-9 places a continuing responsibility on every Member to diligently supervise its employees and agents in all aspects of their futures activities. The rule is broadly written to provide Members with flexibility in developing procedures tailored to meet their particular needs. On certain issues, however, NFA has issued Interpretive Notices to provide more specific guidance on acceptable standards for supervisory procedures.

Currently, information technology is changing nearly every aspect of how Members conduct business, including how customer orders are transmitted. The Board of Directors firmly believes that supervisory standards do not change with the medium used. How those standards are applied, however, may be affected by technology. Therefore, in order to fulfill their supervisory responsibilities, Members must adopt and enforce written procedures to examine the security, capacity, and credit and risk-management controls provided by the firm's automated order-routing systems (AORSs).

NFA recognizes that, given the differences in the size, complexity of operations, and make-up of the customers serviced by NFA Members, there must be some degree of flexibility in determining what constitutes "diligent supervision" for each firm. It is NFA's policy to leave the exact form of supervision up to the Member, thereby providing the member with flexibility to design procedures that are tailored to the Member's own situation. It is also NFA's policy to set general standards rather than to require specific technology. Therefore, other procedures besides the ones described in this Interpretive Notice may comply with the general standards for supervisory responsibilities imposed by Compliance Rule 2-9.

This Interpretive Notice applies to any AORS that is within a Member's control, including an AORS that is provided to the Member by an independent service vendor. While a Member is not, of course, responsible for an AORS chosen by the customer and outside of the Member's control – such as direct access systems provided by exchanges – the Member is nevertheless responsible for adopting procedures reasonably expected to address the trading, clearing, and other risks attendant to its customer relationship.[2]

[2] An AORS may also be outside an IB Member's control if it is provided by the FCM.

Security

General Standard. Members who accept orders must adopt and enforce written procedures reasonably designed to protect the reliability and confidentiality of orders and account information at all points during the order-routing process. The procedures must also assign responsibility for overseeing the process to one or more individuals who understand how it works and who are capable of evaluating whether the process complies with the firm's procedures.

Authentication. The AORS should authenticate the user. Authentication can be accomplished through a number of methods, including, but not limited to, the following:

- Passwords;
- Authentication tokens, such as SecurID cards; or
- Digital certificates.

Encryption. The system should use encryption for all authentication and for any order or account information that is transmitted over a public network, a semi-private network, or a virtual private network. Encryption is less important for a private network that uses dedicated lines and is controlled by the Member (although it can still be a valuable protection).

Firewalls. Firewalls should be used with public networks, semi-private networks, and virtual private networks. A warning should be generated if a firewall is breached.

Authorization. The Member should periodically check each customer to verify that the individuals authorized by the customer to access the AORS are still authorized to do so and to discover whether any passwords (or other forms of authentication) should be disabled.

Periodic Testing. The Member should conduct periodic testing of the security of the AORS using either an independent, internal audit department or a qualified outside party.

Administration. The Member should adopt and enforce written procedures assigning the responsibility for overseeing the security of the AORS to an appropriate supervisor who is familiar by experience or training with computer systems and computer security. The procedures should also provide that appropriate personnel keep up with new developments, monitor the effectiveness of the system's security and respond to any breaches, and update the system as needed so that the AORS maintains a high level of security.

Capacity

General Standard. Members who accept orders must adopt and enforce written procedures reasonably designed to maintain adequate personnel and facilities for the timely and efficient delivery of customer orders and reporting of executions. The procedures must also be reasonably designed to handle customer complaints about order delivery and reporting in a timely manner.

Members may not misrepresent the services they provide or the quality of those services. If a Member represents that it maintains a particular capacity or performance level, it must take the measures necessary to achieve that level.[3]

Capacity Reviews. The Member should adopt and enforce written procedures to regularly evaluate the capacity of the AORS and to increase capacity when needed. The procedures should also provide that the system will be subjected to periodic stress tests by either an independent, internal audit department or a qualified outside party.

The Member should monitor both capacity (how much volume the system can handle before it is adversely impacted or shuts down) and performance (how much volume the system can handle before response time increases), and should assess the AORS's capacity and performance levels based on the major strains imposed on the system. The Member should establish acceptable capacity and performance levels based on its customers' needs and expectations. The Member's procedures should be reasonably designed to provide adequate capacity to meet estimated peak volume needs based on past experience, present demands, and projected demands.

The procedures should also provide for the Member to follow-up on customer complaints about access problems, system slowdowns, or system outages. This follow-up should include identifying the cause of the problem, taking action to correct it, and evaluating ways to prevent it from re-occurring.

Disaster Recovery and Redundancies. The Member should use redundant systems or be able to quickly convert to other systems if the need arises. The Member should also have contingency plans reasonably designed to service customers if the system goes down.

When operational difficulties occur, the Member should provide immediate and effective notification to customers. Notification can be made by a number of methods, including, but not limited to, the following:

- a message on the Member's web site;
- e-mails or instant messages; and/or

[3] Misrepresenting capacity or performance levels or other material information regarding a Member's order-routing system is a violation of NFA Compliance Rule 2-29.

- a recorded telephone message for customers on hold.

Advance Disclosure. The Member should disclose, in advance, the factors that could reasonably be expected to affect the system's performance (e.g., periods of stress). The Member should also educate customers on alternative ways to enter orders when the system goes down or reaches an unacceptable performance level. This disclosure may be made in the account agreement, on the Member's web site, or in any other manner designed to provide this information to current customers before problems occur.

Credit and Risk-Management Controls

General Standard. Members who accept orders must adopt and enforce written procedures reasonably designed to prevent customers from entering into trades that create undue financial risks for the Member or the Member's other customers.[4]

Pre-Execution Controls. An AORS should allow the Member to set limits for each customer based on commodity, quantity, and type of order (e.g., new positions versus liquidating orders) or based on margin requirements. It should allow the Member to impose limits pre-execution and to automatically block any orders that exceed those limits.

The Member does not have to impose pre-execution controls on all customers, however. The Member should review the customer's sophistication, credit-worthiness, objectives, and trading practices when determining whether to impose controls pre-execution or post-execution and deciding what levels to use when setting limits.

Post-Execution Controls. For customers subject to post-execution controls, the system should give the Member the ability to monitor trading promptly and should generate alerts when limits are exceeded. The system should also allow the Member to block subsequent orders, either in their entirety or by kind (e.g., to block orders that create a new position or increase an existing position but not orders that liquidate some or all of an existing position).

"Fat-Finger" Protections. The system should contain protections against "fat-finger" errors. For example, some systems use a "two-click" approach that requires a customer to confirm the order before it is entered. When deciding whether to require a particular customer to use "fat-finger" protections, the Member should again consider the customer's sophistication, credit-worthiness, objectives, and trading practices.

Direct Access Systems. When authorizing (qualifying a customer for) use of a direct access system that does not allow the Member to monitor trading promptly, the Member should utilize available pre-execution controls to set pre-execution limits for

[4] NFA Compliance Rule 2-30 also requires Members to consider an individual customer's ability to accept risk.

each customer, regardless of the nature of the customer. Where the limits are set should be based on the customer's sophistication, credit-worthiness, objectives, trading practices. Members should also consider any other relevant information when deciding whether to authorize a customer to use a direct access system.

Review. Members should use AORSs in conjunction with their credit-review/risk-management systems and should evaluate the controls imposed on each customer as part of their regular credit and risk-control procedures.

* * *

NFA's Self-Examination Questionnaire has been revised to include the WebTrust[SM/TM] Self-Assessment Questionnaire for Availability that was developed (and copyrighted) by AICPA/CICA. Members will be required to review the AICPA/CICA questionnaire as part of their annual self-examination.[5]

NFA Compliance Rule 2-9 requires NFA Members to meet the standards for security, capacity, and credit and risk-management controls that are set out in this Interpretive Notice. It is NFA's policy to leave the exact form of supervision up to the Member, thereby providing the Member with flexibility to design procedures that are tailored to the Member's own situation.

[5] See Interpretive Notice on Compliance Rule 2-9: Self-Audit Questionnaires, NFA Manual, ¶ 9020.

EXHIBIT E

Attached are:

(1) Comment letters received from the following entities:

- (a) Banc One Brokerage International Corporation
- (b) Cargill Investor Services, Inc.
- (c) Chicago Board of Trade
- (d) FC Stone, LLC
- (e) Futures Industry Association
- (f) John W. Henry & Company, Inc.
- (g) Trading Technologies
- (h) Trendstat Capital Management, Inc.
- (i) Xpresstrade, LLC

(2) Record of comments from the FCM, IB, and CPO/CTA Advisory Committees.

From: bob_felker@bankone.com [SMTP:bob_felker@bankone.com]
Sent: Wednesday, October 03, 2001 09:54 AM
To: Yvonne Downs
Subject: Re: Order Routing

Yvonne
Compliance rule 2-9 looks pretty complete. I compared them to the Bank One corporate standards and the rule hits all the high level standards that we have. I assume that the firm's will be able to ensure the compliance with the rule in the same way we would do IB exams.

Kathryn Camp

From: Randall_Romsdahl@cargill.com
Sent: Thursday, November 15, 2001 7:20 PM
To: kcamp@nfa.futures.org
Cc: James_Davison@cargill.com; Dale_Martin@cargill.com; Jan_Waye@cargill.com
Subject: Comments regarding AORS

Kathryn,

This letter follows the recent visit by Thomas Sexton and you to our Chicago office to discuss the NFA's request for comments from the FCM community regarding the NFA's proposed interpretive notice on the Supervision of Use of Automated Order-Routing Systems. Jan Waye and I appreciated your willingness to stop at CIS and share your thoughts about what the NFA is hoping to achieve through the AORS interpretative notice ("IN").

Based our discussions, I would like to share the following points with you.

1. We believe that the IN should be principle-based in order to avoid reference to specific technologies that may become obsolete. The IN should not mandate or force the direction of technological development in the futures and options business.
2. Although the intent of the IN is to provide general guidance for the industry concerning appropriate AORS risk management and control measures by regulated firms, we discussed the unfortunate tendency for such guidance to become "standards." A stronger statement in the IN to the effect that any use of the IN must be made through reliance on the general principles it embodies and not on any particular detail of the IN and that firms practicing procedures other than those identified in the IN will cause the regulated entity to meet its obligation of appropriately supervising AORS business if such other procedures are consistent with the principles embodied in the IN.
3. An appropriately specific, principle-based definition of "independent service vendor" and of what constitutes "member control" of an AORS are needed. Can these definitions be meaningful specific without creating technology mandates?
4. With respect to the "Security' section of the IN, we note that the "General Standard" section should provide a clarifying principle describing the scope of the Member responsibility "during the order routing process." The "order routing process" may well entail significant technology and represent significant performance risks not within the control of the Member. Does the principle that an AORS be reliable necessarily require due diligence standards applicable to Member selections and use of vendors and contractors within an AORS context?
5. The concept of "authorization" loses much of its intended meaning in certain contexts, such as an omnibus account. Should the IN provide guidance for

Members concerning which of the AORS principles are acceptably delegated to customers?

6. To what extent should AORS address concerns created by exchange systems, rules or practices? Exchange risk should be minimized through appropriate internal or regulatory mandated processes and procedures and should not be borne by Members. Exchange risk should be considered by and borne by those who choose to trade on the exchange.
7. The principle of redundancy should be sufficiently flexible to consider disruptions which preclude a Member from providing "immediate and effective" notification to customers. Member knowledge and capability under the circumstances must be considered.
8. The Credit and Risk-Management Controls section should consider the concept of materiality in the concept of risks and appropriate risk controls. For example, "fat-finger" risk controls may not be needed in the context certain trading or certain customers.
9. With respect to those customers for whom pre-trade controls are unneeded or inappropriate, there may be no justification for requiring that the applicable AORS allow such controls to be implemented when there is insufficient reasons for doing so.
10. An IN should be revisited on a regular basis to ensure that the principles remain valid as embodied in the IN and are adequate to cause the intended results.

Regards,

Randy

Anne Spencer Polaski
Assistant General Counsel
Legal Department

November 15, 2001

BY MESSENGER

Kathryn Camp
Associate General Counsel
National Futures Association
200 West Madison Street
Suite 1600
Chicago, Illinois 60606

Re: Draft Interpretive Notice on Compliance Rule 2-9: Supervision of the Use of Automated Order-Routing Systems

Dear Ms. Camp:

The Board of Trade of the City of Chicago, Inc. ("CBOT®" or "Exchange") appreciates the opportunity to comment on the draft Interpretive Notice regarding Automated Order-Routing Systems ("AORS"). The CBOT was pleased to be represented on the Special Committee to Review Technology that contributed industry expertise regarding the issues addressed in this Notice. We also understand that the NFA consulted with industry trade organizations and other NFA committees, in addition to conducting independent research regarding the experience of other industries.

The CBOT agrees that the best way to address these important AORS issues is through interpretive guidance on supervisory responsibilities and believes that an appropriate middle ground needs to be struck between one-size-fits-all requirements and overly general guidelines. Specifically, the Exchange agrees with the need for guidelines regarding security, capacity, and credit and risk-management controls. However, the CBOT is concerned with the implication of prescriptive standards contained in the interpretation, including a proposed requirement that all procedures be written. Although NFA Members may determine that it is beneficial to commit some or all of their AORS procedures to writing, the Exchange does not believe that it is necessary to require all NFA Members to reduce each of their procedures to writing.

Many procedures, when implemented, speak for themselves. For example, with regard to credit and risk-management controls, it is unnecessary to have written procedures for pre-execution or post-execution controls or for "fat-finger" protections if such controls and protections are built into the system. Likewise, if an NFA Member addresses capacity issues by having disaster recovery plans or redundancies, it is their existence, whether or not there is a written description of how they work, that establishes the effectiveness of supervision.

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In keeping with the intent to avoid one-size-fits-all requirements, the Exchange recommends the deletion of the directive that all of the AORS supervisory procedures of every NFA Member be written. Such Members should be permitted to determine for themselves whether their procedures, and which procedures, should be written. In this regard, it should be noted that CFTC Regulation 166.3 and NFA Compliance Rule 2-9 itself only require diligent supervision, and neither require written supervisory procedures.

In connection with each proposed General Standard, the NFA has outlined specific procedures that may comply with the General Standards while stating that these procedures are not the exclusive means of compliance. Nevertheless, in each instance, the General Standards are clearly presented as requirements, and the detailed procedures appear to be prescriptive through the use of the word "should". The NFA should clearly frame the standards and procedures as guidelines, examples, or best practices that might be addressed when utilizing an AORS, while emphasizing that they may be tailored by the particular NFA Member in light of its size, the nature of its customers, and its analysis of the cost-benefit equation. In addition, there should be a clear recognition that technology is continuing to evolve, and that the procedures that are desirable, achievable, and affordable are also likely to change over time.

The CBOT® believes that the procedures set forth in the draft Interpretive Notice provide useful practical guidance to NFA Members. This guidance will help to ensure that NFA Members fulfill their supervisory responsibilities regarding AORS in a manner that will benefit their customers, the Members themselves, and the marketplace. However, as discussed above, the operative term should be "business guidance" rather than mandated standards and procedures.

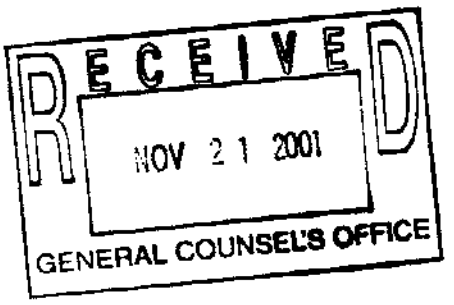
The Exchange valued the opportunity to be represented on the Special Committee that helped to develop general standards regarding AORS, and stands ready to continue to assist with the finalization of this effort and to contribute to other projects affecting the industry in the future.

Sincerely,

Anne Polaski

Anne Polaski
Assistant General Counsel

FCStone LLC
Futures & Commodities



November 13, 2001

Kathryn Camp
Associate General Counsel
National Futures Association
200 West Madison
Suite 1600
Chicago, IL 60606

Re: Interpretive Notice: Automated Order-Routing Systems

Dear Ms. Camp:

FCStone, LLC ("FCStone") is a futures commission merchant and a Member of the National Futures Association ("NFA") with clients located throughout the world. As such, we utilize various means of communication to service our client's needs. The following comments reference our experiences.

We concur that NFA Compliance Rule 2-9 places a continuing responsibility on every Member to supervise its employees and agents with respect to their futures activities. Evolving information and communication technology does not change this requirement. Further, we concur that because of the differences in the size and complexity of the operations of NFA Members and the make-up of their customer base, Members must have flexibility in determining how they can best structure their operations to meet the intent of the Compliance Rule 2-9. Indeed, one size does not fit all.

We believe that we have a supervisory responsibility over orders entered though an automated order-routing system ("AORS") under our control. However, that responsibility is no different than what currently exists when we receive an order from a client over the phone. The concerns a Member has regarding the use of new technology for order placement are no different than already exists today, regardless of whether those are concerns regarding security and confidentiality of customer transactions, capacity to handle those transactions, or the credit risks associated with those transactions.

Mailing Address: P.O. Box 4887 • Des Moines, Iowa 50306-4887
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The use of encryption, firewalls, the periodic checking of authorization to place orders using an AORS as well as the periodic testing of the capacity of the AORS, to the degree and frequency applicable, are practices we believe Members now follow in the routine course of their business. These are not new concepts. Thus, we believe that the interpretive notice should only remind Members of the security issues and not reference the specific application of practices. If a customer believes a Member has acted negligently regarding the preceding, that customer has a number of avenues under the rules of the NFA, CFTC and/or civil proceedings to seek recovery of perceived damages.

Again, we believe the above comments regarding current practices in the industry are also applicable to the proposed requirements under the headings Capacity and Credit and Risk-Management Controls. If a firm does not have adequate telephone capacity it is well aware that it may face claims from and/or will lose customers. Further, if it doesn't have procedures to monitor order flow it will face financial risks. We do not have an interpretive notice similar to the proposed notice regarding these issues for the current method of order placement. Yet, these same issues are present.

We think the NFA is on the right track in reminding its members that as technology evolves these issues still exist. Further, it is appropriate to remind Members that the means of addressing these issues may require new tools and/or procedures, while even identifying some of the tools and/or procedures a Member may want to consider utilizing. However, we believe the proposed interpretive notice regarding Automated Order-Routing Systems goes too far in that it dictates how those tools and/or procedures are to be used.

Yours truly,

FCSTONE, L.L.C.

Paul G. Anderson
President

FUTURES INDUSTRY ASSOCIATION
INC.

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

November 15, 2001

Ms. Kathryn Camp
Associate General Counsel
National Futures Association
Suite 1600
200 West Madison Street
Chicago IL 60606

Re: Interpretative Notice Regarding Automated Order Routing Systems

Dear Ms. Camp:

The Futures Industry Association ("FIA") welcomes this opportunity to comment on the National Futures Association's ("NFA's") proposed Interpretative Notice Regarding Automated Order Routing Systems, which was released for comment on August 31, 2001 ("Notice"). FIA is a principal spokesman for the commodity futures and options industry. Our regular membership is comprised of approximately 50 of the largest futures commission merchants ("FCMs") in the United States, each of which is also a member of NFA. Among our associate members are representatives from virtually all other segments of the futures industry, both national and international. Reflecting the scope and diversity of our membership, FIA estimates that our members effect more than 90 percent of all customer transactions executed on US contract markets.

FIA is pleased to support NFA in its efforts to develop general standards for automated order routing systems. As the self-regulatory organization for the US futures industry, with particular responsibility for the protection of commodity futures market participants, providing such guidance to its members is certainly an appropriate role for NFA. However, as discussed in greater detail below, FIA believes that the proposed Notice is far too prescriptive.

We recognize that the Notice states that "other procedures besides the ones described in this Interpretative Notice may comply with the general standards for supervisory responsibilities." Nonetheless, the Notice goes on to advise members that, among other technologies and procedures: (1) the system *should* use encryption for all authentication; (2) firewalls *should* be used; (3) members *should* conduct periodic testing of the security of the system; and (4) the member *should* use redundant systems. [Emphasis supplied.] The Notice concludes with the warning that "NFA Compliance Rule 2-9 requires NFA Members to meet the standards for security, capacity, and credit and risk controls that are set out in this Interpretative Notice." Members that fail to do so presumably could be subject to a disciplinary proceeding.

FIA strongly believes that any guidance NFA provides should be general in nature to allow firms the flexibility to adopt standards that are reasonable designed to address their business needs. We

are concerned that an unintended consequence of the Notice in its present form is that members electing to adopt procedures different from those set forth in the Notice would bear a greater burden in subsequent SRO audits in establishing the adequacy of their supervisory procedures. Such member firms would have a similar burden in any judicial proceeding or arbitration brought by users of automated order routing systems.

For these reasons, and subject to our comments below, FIA strongly recommends that NFA recast the Notice as a general guideline, without specifying particular standards and technologies that members should consider in developing supervisory procedures with respect to automated order routing systems.

General Comments

In preparing this comment letter, FIA reviewed a number of documents published by various US securities regulatory authorities, the International Organization of Securities Commissions ("IOSCO") and the General Accounting Office ("GAO") that appear to be relevant to the issues discussed in the Notice.[1] However, none of these documents appears to mandate the detailed requirements that implementation of the Notice would impose on members. To the contrary, these documents are more narrowly focused, emphasizing in particular the obligation of broker-dealers to assure the operational capacity of their systems and to provide adequate disclosure to their customers concerning the risks of trading through such systems.

For example, in Staff Legal Bulletin No. 8, the SEC staff only "seeks to emphasize to broker-dealers the importance of having adequate capacity to handle high volume or high volatility trading days, and conducting capacity planning on a regular basis." NASD reinforces this guidance in Notice to Members 99-11 and Notice to Members 99-12. The IOSCO report states that regulators "may *wish to consider* whether online brokers, as a matter of business interest, legal requirements or regulatory guidance, are prepared to address risks relating to system capacity, resilience and security" by addressing several issues, including certain of those discussed in the Notice. [Emphasis supplied.] However, the report makes no definitive recommendations in this regard.

Only the OCIE Report discusses matters such as encryption, firewalls and passwords. However, the OCIE Report does not purport to require all broker-dealers to employ such techniques to assure the security of their systems. It simply describes current practices and makes

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[1] (1) Securities and Exchange Commission ("SEC") Staff Legal Bulletin No. 8 (MR), September 9, 1989; (2) SEC Office of Compliance Inspections and Examinations ("OCIE"): Examinations of Broker-Dealers Offering Online Trading: Summary of Findings and Recommendations, January 25, 2001; (3) SEC Notice of Proposed Rulemaking, Operational Capability Requirements of Registered Broker-Dealers and Transfer Agents and Year 2000 Compliance, March 11, 1999; (4) GAO Report on On-Line Trading, July 20, 2001; (5) National Association of Securities Dealers ("NASD") Notices to Members 98-66, 99-11 and 99-12; New York Stock Exchange ("NYSE") Notices to Members 89-6, 92-15 and 92-43; and (6) IOSCO Internet Task Force Report on Securities Activity on the Internet II, June 2001.

recommendations with respect to issues that broker-dealers offering on-line trading should consider. The OCIE Report, therefore, contrasts sharply with the Notice, which advises members that "NFA Compliance Rule 2-9 requires NFA Members to meet the standards for security, capacity, and credit and risk management controls that are set out in this Interpretative Notice."

Specific Comments

Written Supervisory Procedures Generally. In general, FIA agrees with NFA that member firms should have special written supervisory procedures governing their business activities. Nonetheless, we do not believe that written supervisory procedures are required when appropriate safeguards are built into the automated order routing system itself. This latter approach would be consistent with that of the NYSE in its releases. We recommend that the Notice be revised accordingly.

Security: Authentication, Encryption and Firewalls. FIA agrees that members that accept orders should have procedures in place reasonably designed to protect the reliability and confidentiality of orders and account information during the order routing process. The choice of appropriate procedures, however, should be left to each member. Authentication methods, encryption and firewalls may describe the more obvious means of assuring security of a system that may be available currently. However, it is by no means clear that these procedures are always available or that they should be mandatory for all member firms regardless of their size, structure or type of business. Moreover, as NFA has recognized, technology is constantly evolving. Members should not be locked into using encryption and firewalls, for example, if more appropriate and effective security procedures are developed or identified. Finally, we oppose the proposed requirement that a warning be generated if a firewall is breached. We believe that the current technology is too imprecise in distinguishing actual breaches of firewalls that threaten the security of a system from other events.

Security: Authorization. FIA strongly objects to the proposed requirement that members "should periodically check each customer to verify that the individuals authorized by the customer to access the AORS are still authorized to do so and discover whether any passwords (or other forms of authentication) should be disabled." This proposed requirement unnecessarily and unfairly shifts the burden of responsibility in this regard from the customer, where it rightly belongs, to the member firm. This requirement would also contradict many customer account agreements, which clearly place responsibility with the customer to advise the member firm whenever a change is made in the identity of individuals authorized to enter trades on behalf of the customer or the security of passwords has been compromised.

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

Security: Administration. The responsibility for assuring the security of an order routing system rests with the firm and not a single individual. It is the member firm's responsibility to determine the number of people who should be responsible for the security of the member's system. It is not necessary or appropriate to require that one individual be held responsible.

Capacity: Disaster Recovery and Redundancies. FIA agrees that a member firm should have contingency plans reasonably designed to service customers if a system fails. However, it is not appropriate to require a member firm to use a redundant system or to be able to convert to other systems if the need arises. Such a requirement could impose a significant financial and operational burden on member firms. What happens in the event of a system failure is properly a matter to be discussed between the member and the client. Additionally, any back-up procedures the member makes available to its customers are reasonable in view of the member's size, structure and type of business.

Capacity: Advance Disclosure. A member firm should not have to disclose in advance every factor that could possibly affect the system's performance. It should be sufficient to highlight the material factors. Again, the more important point is that a member firm should adequately describe the procedures the customer should follow in the event of a system failure.

Credit and Risk Management Controls: Pre-Execution and Post Execution Controls. Provided it is clear that the decision whether to impose pre-execution or post-execution controls remains with the member firm, FIA does not object to this standard. Nonetheless, we understand that the systems intended to permit a firm to impose pre-execution controls are not well developed. In particular, complex trading strategies involving options are not well suited for pre-execution control processes. Similarly, the requirement with respect to post-execution controls appears to assume that a member firm will always be able to monitor trading "promptly." This is not always possible, especially where the customer may execute a portion of its transactions through the telephone or through an executing broker. These trades are not taken into account by an automated order routing system, and often are not seen electronically on trade date. Separately, FIA agrees that firms should consider "fat finger" controls for certain customers. However, it is also important to note that, in many systems, the customer has the ability to override such controls.

Credit and Risk Management Controls: Direct Access Systems. We object to the proposed requirement that member firms use pre-execution controls whenever a customer is allowed to use a direct access system that does not allow a member to monitor trading promptly. We agree that a member firm should consider whether to impose such controls. However, that decision, which is a business decision, should rest with the member firm. It is also important to note that certain exchange-provided terminals do not permit carrying firms to impose pre-execution controls. Moreover, exchanges are providing the API interfaces to order routing vendors that do not provide pre-execution control ability. These vendors often market their systems directly to the end-users. FIA recognizes that Notice provides that a member is not responsible for a system chosen by the customer, including systems provided by exchanges. Nonetheless, within the same sentence, NFA states that the member "is nevertheless responsible for adopting procedures reasonably expected to address the trading, clearing, and other risks attendant to its customer relationship." NFA should first address this issue directly with the exchanges and not the member firms. Any exchange-sponsored systems should include these controls, which enhance the integrity of the entire system.

Conclusion

For all of the above reasons, FIA does not believe that that Notice should be adopted in its present form. Rather, we believe the Notice should be substantially rewritten and published as a guideline, describing issues that member firms should consider in connection with implementing reasonable supervisory procedures governing the use of automated order routing systems by their customers. We would be pleased to work with NFA to this end.

Sincerely,

John M. Damgard
President

cc: Daniel J. Roth, Senior Executive Vice President
Thomas W. Sexton, General Counsel

Kathryn Camp
From: David_Kozak@jwhmail.com
Sent: Monday, October 29, 2001 1:33 PM
To: kcamp@nfa.futures.org
Subject: Proposed Interpretive Notice Regarding Automated Order-Routing Systems

Dear Ms. Camp:

This comment letter in response to the Request for Comments on the above-referenced Interpretive Notice is submitted on behalf of John W. Henry & Company, Inc., a registered commodity trading advisor (JWH). Several of JWH's affiliates are registered as commodity trading advisors or commodity pool operators as well. As a substantial user of regulated futures markets in the United States, JWH has a direct interest in the efficient functioning of those markets. JWH supports the issuance of the Proposed Interpretive Notice Regarding Automated Order-Routing Systems and believes that it would be beneficial in establishing a framework for the implementation and operation of AORS throughout the industry. JWH's comments are directed primarily to the impact that the Interpretive Notice can have in clearly stating the terms of AORS to users of the regulated markets, including those like commodity trading advisors who trade for their clients on a discretionary basis through a power of attorney. The greater flexibility provided to the industry by an Interpretive Notice, as opposed to a rule, is preferable because it allows greater innovation and should permit the development of greater competion among providers of brokerage services.

As a preliminary matter, JWH believes that the draft Interpretive Notice is written from the perspective of AORS that are already in operation. JWH believes that the Interpretive Notice should also address the obligation of futures commission merchants (FCMs) to conduct thorough testing and review of AORS before placing them in operation and offering them to clients.

As AORS are offered to clients, JWH, believes that disclosure should be required to be made to clients in advance about the features of the particular AORS being offered, and not only about potential operation /performance breakdowns, as seems to be contemplated under the Advance Disclosure section of the draft Interpretive Notice. Disclosures should be sufficient to permit a client to compare FCMs' AORS if it chooses to devote sufficient time to determine the differences among competing AORS.

Under Credit and Risk-Management Controls, JWH believes that the requirement that consideration be given to client sophistication be specifically qualified by reference to the ability to satisfy this requirement by looking to the sophistication of parties who direct a customer's trading, such as a commodity trading advisor and not solely to the sophistication of the customer.

In the same section, reference is made to pre-execution and post-execution controls that may be imposed on customers by a FCM. These terms should be specifically defined in the Interpretive Notice.

Sincerely yours,

David M. Kozak

General Counsel, Vice President and Secretary , John W. Henry & Company, Inc.

Comments on the Interpretive Notice for AORS

As a member of the committee that helped create the foundation for the Interpretive Notice, I attempted to provide some "real world" examples regarding the use of electronic order routing systems. While I agree that the notice needs to be general since various members will apply various means of supervision, I do feel that the notice should point out what currently transpires between exchange, member, and customer in the chain of electronic trading. This chain will help define best practices currently used in the industry **(request for comment# 3)**.

The four largest marketplaces for electronic futures trading in the US today are Eurex, CME, CBOT, and LIFFE. While not all fall under US regulation it is of interest to note how they control supervision of member over customer in regards to market access.

1)Eurex- All NCM (non clearing members) must have a relationship with a GCM (general clearing member). Trade execution of NCM customers is reported directly to GCM. NCM cannot gain access to the marketplace without approval to Eurex of GCM. Market participants are connected to the exchange via a MISS (Member Integrated Server System) device. Before any electronic trading can begin, via native front-end or an ISV (independent software vendor) screen- Eurex requires that the MISS be set up with limited risk parameters. The MISS device requires the following info before any trading can begin

a)customer trading id
b)customer password
c)products the customer can trade
d)maximum quantity for given trade of selected product

As you can see before any supervision takes place on the member side- the exchange requires some basic risk/supervision setup for electronic trading.
The member can then use an ISV risk system to perform additional pre- and post-risk supervision.

2)CBOT- is part of the ACE (Alliance of CBOT/Eurex) system and therefore has an identical setup to the Eurex procedure above.

3)CME- direct exchange access is now granted to both members and non-members of the exchange. However, if a non-member is to have direct access to the exchange, **they must have their clearing member representative show/ and sign-off on how that clearing member has supervision access.**

For example if I am receiving a direct feed from the CME and clear via firm ABC, firm ABC would need to have access to my AORS. This access may come from a GLWN Globex supervision screen, or a direct line (VPN or dial-up) to the ISV system providing exchange connectivity. Firm ABC would then use tools provided by the ISV for pre and post trade execution.

4)LIFFE- access to the LIFFE marketplace can only be provided once the AORS has passed information thru a SUN SPARC station acting as the LIFFE gateway.

This LIFFE gateway requires specific trading information to be entered before any electronic access can be provided.

a) all trader id's are provided by the LIFFE exchange. Along with the id's, the LIFFE exchange provides encrypted passwords that must be associated the given Id. The LIFFE exchange reissues these id's and passwords during the year.

Therefore, the exchange, and not the member initially handle creation of Id's and passwords.

b) the Sun SPARC station must have which trader id can trade which product. If a trader id does not have a given product associated, it will not be able to trade.

The information above should help identify best practices that are already being used in regards to supervision of electronic futures trading.

In reference to how specific the information needs to be, **Request for Comment #4**, it is difficult to assign specific technical requirements since many firms view electronic access in varying degrees of importance. There are some firms that view their electronic infrastructure; including network setup, security, degrees of redundancy etc., as their competitive asset over other firms.
Certain ISV's even offer co-location facilities that bring these technological upgrades to a number of firms under one roof, but it may be unreasonable to require all firms to have such items in place.

Since the overall tone of the notice is general, and not too specific, you do not need to worry that technical costs will be deemed to high (**Request for Comment #5**). You may want to include the exchange costs, as examples, that are associated with current exchange connectivity. These may include line fees, exchange gateways, routers etc.

Please contact me if you have any questions on the information provided.
Steve Monieson
VP Sales
Trading Technologies
312-782-7310

October 22, 2001

Comments on Automated Order-Routing Systems:
By Tom Basso, CEO of Trendstat Capital Management, Inc in Scottsdale, Arizona

With the flow of orders increasingly becoming an electronic order flow, rather than a traditional "telephone based" order flow, the interpretive Notice is quite timely. As is often the case with notices from self-regulatory bodies, such as the NFA, or rules and regulations set by the governing bodies, such as the CFTC, many of the items listed in the Notice should be long-term sound business practices already in place with any firms that wish to remain a serious execution merchant in the industry. Helping to remind those not putting some of these things in place may just be the nudge necessary to keep the industry strong and moving forward with these new technologies.

There is a certain supervisory duty of the Member to supervise order flow in the telephone world. Things like recorded lines, time stamping, knowing the client well enough to know that the order is appropriate both in size and nature were all ways of protecting the Member from the potential risk of inappropriate trading harming both the Member firm and, potentially, the integrity of the markets.

The electronic world should be no different, and in the end, even easier to supervise order flow. I can't believe any firm would be foolish enough to not have supervisory procedures covering fat finger situations, inadequate margin capabilities, size of order provisions, security of the order flow and privacy policies. Any firm failing to put these things in place does so to their eventual embarrassment or peril. The Interpretive Notice simply articulates these items and forces firms to take a hard look at what they are doing in these areas.

Because the media is different, the supervisory policies will undoubtedly look slightly different, but the intent should be the same. The policies should make sure that the order is appropriate in both size and nature for the client. The policies should make sure that adequate margin is available to cover the trade. The policies should protect against ridiculous fat-finger types of order flow to the extent that they can. Finally, the policies should provide the client some protection to privacy and security.

Details will be different at every firm. Because of the diversity of technical solutions to accomplishing the above, we should let each firm decide on how best to arrive at their own version of this industry best practice, but arrive they must. I would therefore commend the committee's decision to keep details to a minimum and establish broad, reasonable guideline for the each Member to address, if they haven't done so already. I believe that firms that have taken a step towards this type of order flow would not find anything in the Notice that they aren't already doing. Conversely those firms not following these guidelines should be very concerned over meeting these guidelines or getting out of the execution business.

On the cost of complying with these guidelines, I would say that if you want to handle automated routing systems, these costs should be a normal part of getting into this part of the business. To not do it is similar to building a house without a suitable foundation. Eventually the house falls down. I don't believe that the costs of complying with these guidelines would be prohibitive. Those firms wanting to be a part of automating order routing will spend the capital required to do these things well.

On the issue of when does a Member have control over an AORS, I would suggest the industry view this from the client's viewpoint and realize that we all serve the ultimate client that participates in the futures industry. They are going to demand security and safety of their capital. If any actions by an AORS will impact or threaten the safety and security of our client's capital, then the Member firm must have enough control over the system to protect the integrity of the Member's capital and the safety

and security of the client's assets. To do less may damage the Member's ability to survive and gives the industry a serious credibility problem with investors.

On the issue of safe harbors for those firms adopting a best practices, I would say they should be doing this because it makes excellent business sense, so a safe harbor should not be required to motivate anyone to use these guidelines. They should be adopting these practices to ensure they will survive in this new trading medium.

Tom Basso, CEO
Trendstat Capital Management, Inc.

Kathryn Camp
From: Dan O'Neil [danny@xpresstrade.com]
Sent: Thursday, October 04, 2001 10:16 AM
To: Kathryn Camp
Subject: RE: Interpretive Notice...

Morning, Kathryn,

Great, thanks for the update. From what I've read, it seems that your Committee is on the right track. It's extremely important, particularly to smaller FCMs with perhaps more modest technology budgets than some of the larger firms, that the final version of the new Rule not be overly demanding. While things such as 100% security and 100% reliability are certainly noble goals for which we all should strive, I think anyone with experience in this field would have to tell you honestly that these are pretty elusive goals, and there's absolutely no limit on the amount of dollars that can be spent in pursuit of them, often with diminishing marginal returns. I would hate to see the NFA adopt a Rule that is so stringent and burdensome that smaller firms really struggle to meet the requirements. I would respectfully submit that the competitive marketplace will do as a fine a job as any NFA Rule—firms that don't offer a reasonable amount of security and dependability, for instance, will have an awfully difficult time attracting and satisfying clients. If firms don't do a good job in such areas, public customers will vote with their feet and will migrate toward firms that are more on the ball. But I think your Committe seems to understand and is mindful of this concern.

The only other fear of ours is the prospect of an enormous documentation job. Your Committee's draft seems to contemplate written procedures on just about every technology-related issue, and this has the potential to become an extremely time and labor intensive undertaking. You certainly have a number of solid, worthwhile ideas that firms should adopt in practice if they haven't already. But requiring them to put together voluminous procedures manuals would be a shame. Technical staff is one of the largest expenses in an online brokerage operation as well as arguably the most difficult resource to find and retain. We'd hate to have to devote staff members like these folks to a massive documentation job.

Thanks again for your note, Kathryn, and for your consideration.

Regards,

Dan

At 09:45 AM 10/04/2001 -0500, you wrote:

> In light of the events of September 11, we have extended the comment period to November 15. We expect to discuss the comments with the Special Committee in December and to take a final proposal to the Executive Committee in January and the Board in February. Although I don't know what kind of a date we would be looking at for full compliance, I'm sure we will

be flexible and work with the industry to make the transition as painless as possible.

Dan O'Neil, Principal
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Advisory Committee Comments
on the Proposed Interpretive Notice
Regarding Automated Order-Routing Systems

The FCM, IB, and CPO/CTA Advisory Committees met on November 26, 2001, November 30, 2001, and November 28, 2001, respectively. At those meetings, they reviewed the nine comment letters filed in response to Notice to Members No. I-01-15, Request for Comments on Proposed Interpretive Notice Regarding Automated Order-Routing Systems. Each Committee also provided its own comments on the notice.

The FCM Advisory Committee voted to comment that NFA should not issue interpretive guidance on the use of AORSs. In the Committee's view:

- NFA Members already have all the guidance they need, so the notice is unnecessary;

- The notice imposes obligations that are not present for orders entered over the telephone; and

- Decisions regarding AORSs should be a matter of business judgment, not regulation. The guidance issued in the securities industry does not impose the same regulatory obligations on firms, and NFA should not be a leader in this area.

The IB and CPO/CTA Advisory Committees supported the proposed interpretive notice. Both Committees agreed with the general standards described in the notice and suggested that the Special Committee clarify that the remaining standards are matters Members should consider in complying with the general standards.

(kpc/OrderRouting/Advisory Committee Comments)