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

December 3, 1985

Ms. Jean A. Webb
Secretary of the Commission
Commodity Futures Trading Commission
2033 K Street, N.W.
Washington, D.C. 20581

Re: **National Futures Association,** Proposed Amendments to Bylaws 301(a)(i), 301(h), 301(j), 305 Schedule A Section I(f) and 703; Proposed Compliance Rule 2-30; Proposed Amendments to Code of Arbitration Sections 4, 6 and 9; and Proposed Guideline for the Disclosure by FCMs and IBs of Costs Associated with Futures Transactions.

Dear Ms. Webb:

Pursuant to Section 17(j) of the Commodity Exchange Act ("Act"), as amended, National Futures Association ("NFA") hereby submits to the Commodity Futures Trading Commission ("CFTC" or "Commission") for review and approval the following proposed amendments to NFA Bylaws, Compliance Rules and Code of Arbitration and a Guideline under NFA Compliance Rule 2-4. The proposed amendments, Rule and Guideline were unanimously approved by NFA's Board of Directors at its meeting on November 21, 1985.

I. THE AMENDMENTS, COMPLIANCE RULE AND GUIDELINE

A. Amendments to NFA Bylaws 301(a)(i), 301(h), and 301(j). Additions are underscored and deletions are placed within [brackets].

BYLAWS
OF
NATIONAL FUTURES ASSOCIATION

* * *

CHAPTER 3
MEMBERSHIP AND ASSOCIATION WITH A MEMBER

Bylaw 301. Requirements and Restrictions.

(a) Eligibility for Membership.

(i) No person, unless eligible for Membership in the contract market, commercial firm or commercial bank category, shall be eligible to become or remain an

NFA Member or associated with a Member unless such person is registered, temporarily licensed or exempt from registration under the Commodity Exchange Act (hereinafter "Act") or the rules of the Commodity Futures Trading Commission (hereinafter "Commission"). [If a person becomes ineligible to remain a Member or associated with a Member pursuant to this section of paragraph (a) then such person's Membership or registration with NFA as an Associate shall terminate. Such termination shall not relieve the Member or Associate of any responsibility under the NFA Code of Arbitration, Compliance Rules or Bylaws for activities prior to termination, or of the obligation to pay any dues, assessments, fines, penalties or other charges theretofore accrued and unpaid.]

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(h) Termination of Membership and Associate Membership.

The membership or associate membership of any person may be terminated as set forth below. Termination of a person's membership or associate membership pursuant to paragraphs (i) through (vii) shall not relieve the Member or Associate of any responsibility under the NFA Code of Arbitration or Compliance Rules for activities prior to termination, or of the obligation to pay any dues, assessments, fines, penalties or other charges theretofore accrued and unpaid.

(i) Termination of Temporary License.

The termination of the temporary license of any Member or Associate shall also terminate such person's membership or associate membership unless such person remains otherwise eligible for membership under Bylaw 301(a).

(ii) Withdrawal of or Failure to Renew Registration.

The membership of any Member that withdraws or fails to renew all registrations under the Act may be summarily terminated by order of the President on seven days' written notice.

(iii) Termination of Employment as Associate.

Each Member shall promptly inform the Secretary of the termination of employment of any registered Asso-

ciate with the Member. If such person is no longer listed as an Associate of any Member following such termination, the individual's registration with NFA as an Associate shall also terminate unless the Secretary is notified in writing by another Member, within 60 days thereafter, that such person has become associated with it.

(iv) Resignation.

A Member, unless under investigation or disciplinary charges by NFA, may resign at any time by filing written notice with the Secretary. [In addition, any Member, unless under investigation or disciplinary charges by NFA, that withdraws or fails to renew all registrations under the Act shall be deemed to have resigned from NFA membership. Such resignation shall be effective on the date the Member's registrations are withdrawn or expire. Resignation shall not relieve the Member of any responsibility under the NFA Code of Arbitration or Compliance Rules for activities prior to resignation, or of the obligation to pay any dues, assessments, fines, penalties or other charges theretofore accrued and unpaid.]

(v) Failure to Notify of Address Change (see Bylaw 301(i)).

(vi) Default in Payment of Dues (see Bylaw 1303).

(vii) Revocation (see Bylaw 301(g)).

[(j) Termination of Associate.

Each Member shall promptly inform the Secretary of the termination of employment of any registered Associate with the Member. If such person is no longer listed as an Associate of any Member following such termination, the individual's registration with NFA shall lapse unless the Secretary is notified in writing by another Member, within 60 days thereafter, that such person has become associated with it. Lapse of any individual's registration with NFA as an Associate shall not relieve the Associate of any responsibility under the NFA Code of Arbitration, Compliance Rules, or Bylaws for activities prior to other charges theretofore accrued and unpaid.]

B. **Proposed Amendment to NFA Bylaw 305 Schedule A Section I. Part (f) of Section I, as set forth below, is an addition to Schedule A of Bylaw 305.**

BYLAWS
OF
NATIONAL FUTURES ASSOCIATION

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CHAPTER 3
MEMBERSHIP AND ASSOCIATION WITH A MEMBER

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Bylaw 305. Registration and Proficiency Requirements.

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Schedule A

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I. Registration

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(f) Temporary Licenses for Guaranteed Introducing Brokers.

(i) Qualifications

Notwithstanding any other provisions of these regulations, NFA may grant a temporary license to any applicant for registration as an Introducing Broker upon the contemporaneous filing with NFA of:

(A) A properly completed Guarantee Agreement (Form 1-FR Part B) from an FCM which is eligible to enter into such an agreement pursuant to CFTC Regulation 1.10(j)(2); and

(B) A properly completed Form 7-R; and

(C) A properly completed Form 7-R Schedule A; and

(D) A properly completed Form 8-R for all persons that are principals and branch managers which contain no "yes" answers indicating that the

applicant may be subject to a statutory disqualification under the Commodity Exchange Act; and

(E) Legible fingerprints on cards provided by NFA for all persons that are principals and branch managers: Except that, principals currently registered as associated persons or principals of current registrants must complete and file only the Disciplinary History portion of Form 8-R to satisfy the filing requirements of (i)(D) and (i)(E) if they are not required to register as an associated person of the applicant; and

(F) Proof of satisfaction of the applicable proficiency requirements set forth in this Schedule A, or exemption therefrom, by all branch managers and all principals acting in a capacity which requires registration as an associated person; and

(G) All of the other forms and documents, properly completed, that are required to become registered as an Introducing Broker and to become an NFA Member.

A guarantee agreement filed in connection with (i)(A) shall become effective upon the granting of the temporary license.

(ii) Withdrawal of Application

Failure of an applicant to respond to NFA's request for clarification of application information or resubmission of fingerprints will be deemed to be a withdrawal of the registration application and an immediate termination of the temporary license.

(iii) Restrictions Upon Activities

(A) An applicant for registration as an Introducing Broker who has received written notification that a temporary license has been granted may act in the capacity of a guaranteed Introducing Broker, subject to all CFTC Rules, Regulations and orders and all requirements of an NFA Member.

(B) An applicant for registration as an Introducing Broker who has received a temporary license may be guaranteed by an FCM other than the FCM which provided the initial guarantee agreement described in (i)(A): Provided that, NFA receives written notice of the termination of the existing guarantee agreement and a properly completed guarantee agreement (Form 1-FR Part B) which shall by its terms become effective immediately upon the termination of the existing guarantee agreement. Such notice of termination and such new guarantee agreement must be received by NFA at least ten days prior to the effective date of the termination or within such other period of time as NFA may allow.

(iv) Termination

(A) A temporary license shall terminate:

(1) Five days after service upon the applicant of a notice by NFA that the applicant for registration may be found subject to a statutory disqualification from registration; or

(2) Immediately upon termination or suspension of the applicant's or guarantor FCM's NFA membership or upon termination of the applicant's guarantee agreement in accordance with NFA Financial Requirements Section 9 and CFTC Regulations 1.10(j)(4)(ii) or (j)(5) unless a new guarantee agreement is filed in accordance with (f)(iii)(B) above; or

(3) Upon failure of an applicant to respond to NFA's request for clarification of application information or resubmission of fingerprints pursuant to (ii) above.

(B) Upon termination, the applicant may not engage in any activity which requires registration as an Introducing Broker.

(v) Relationship to Registration and Membership

(A) A temporary license shall not be deemed to be a registration or to confer any right to such registration.

(B) The granting of a temporary license shall constitute the granting of NFA membership.

(C) Termination of a temporary license will affect NFA membership as described in Bylaw 301(h)(i).

(D) The renewal date of a registration granted from a temporary license will be determined upon registration with such date not causing a registration to expire less than one year nor more than two years from the date of the granting of registration.

(E) Unless a temporary license has terminated, a temporary license shall become a registration upon the earlier of:

(1) A determination by NFA that the applicant is qualified for registration as an Introducing Broker; or

(2) The expiration of six months from the date of its issuance.

C. Proposed Amendment to NFA Bylaw 703. Additions are underscored.

BYLAWS
OF
NATIONAL FUTURES ASSOCIATION

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CHAPTER 7
COMMITTEES

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Bylaw 703. Advisory Committees.

The Board shall appoint advisory committees, not having or exercising the authority of the Board, including a committee to advise the Board on FCM matters and a committee to advise the Board on matters relating to commodity pool operators and commodity trading advisors. No person then serving as member of the Board shall simultaneously serve as a member of any NFA advisory committee. Each member of an advisory committee shall serve for three (3) years, except that the

terms initially established shall be staggered, or until the member's successor is appointed and qualified, or until the member's death, resignation, ineligibility or removal. A vacancy in an advisory committee shall be filled in the manner prescribed in Bylaw 601 for officers. A Committee member may be removed by the Board whenever in its judgment the best interests of NFA will be served thereby.

D. Proposed Compliance Rule 2-30.

COMPLIANCE RULES

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Part 2 - RULES GOVERNING THE BUSINESS CONDUCT
OF
MEMBERS REGISTERED WITH THE COMMISSION.

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Rule 2-30. Customer Information and Risk Disclosure.

(a) Each Member or Associate shall, in accordance with the provisions of this Rule, obtain information about its futures customers who are individuals and provide such customers with disclosure of the risks of futures trading.

(b) The Member or Associate shall obtain the information and provide the risk disclosure at or before the time a customer first opens a futures trading account to be carried or introduced by the Member, or first authorizes the Member to direct trading in a futures account for the customer.

(c) The information to be obtained from the customer shall include at least the following:

(1) the customer's true name and address, and principal occupation or business;

(2) the customer's current estimated annual income and net worth;

(3) the customer's approximate age; and

(4) an indication of the customer's previous investment and futures trading experience.

(d) The risk disclosure to be provided to the customer shall include at least the following:

(1) the Risk Disclosure Statement required by CFTC Regulation 1.55, if the Member is required by that Regulation to provide it;

(2) the Disclosure Document required by CFTC Regulation 4.31, if the Member is required by that Regulation to provide it; and

(3) the Options Disclosure Statement required by CFTC Regulation 33.7, if the Member is required by that Regulation to provide it.

(e) In the case of an account which is introduced by an FCM or IB or for which a CTA directs trading, it shall be the responsibility of the Member soliciting the account to comply with this Rule.

(f) A Member or Associate shall be entitled to rely on the customer as the sole source for the information obtained under Section (c) of this Rule and shall not be required to verify such information.

(g) Each Member or Associate shall make or obtain a record containing the information obtained under Section (c) of this Rule at the time the information is obtained. If a customer declines to provide the information set forth in Section (c) of this Rule, the Member or Associate shall make a record that the customer declined, except that such a record need not be made in the case of a non-U.S. customer. Subject to the provisions of Section (i) of this Rule, a Member may open, introduce or agree to direct a futures trading account for a customer only upon the approval of a partner, officer, director, branch office manager or supervisory employee of the Member. Each Member shall keep copies of all records made pursuant to this Rule in the form and for the period of time set forth in CFTC Regulation 1.31.

(h) Each Member shall establish and enforce adequate procedures to review all records made pursuant to this Rule and to supervise the activities of its Associates in obtaining customer information and providing risk disclosure.

(i) Nothing herein shall relieve any Member from the obligation to comply with all applicable CFTC Regulations and NFA Requirements.

E. **Proposed Amendments to NFA's Code of Arbitration Sections 4, 6 and 9. Additions are underscored and deletions are placed within [brackets].**

CODE OF ARBITRATION

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Section 4. Arbitration Panel.

(a) Appointment of Panel.

All arbitration proceedings under this Code shall be conducted before an arbitration Panel consisting of three NFA Members or individuals connected therewith (one such Member or individual designated as panel Chairman) appointed by the President, except that where the aggregate amount of the customer's claims [(including interest)] (exclusive of interest and costs) plus the aggregate amount of any counterclaims [(including interest)] (exclusive of interest and costs) do not exceed $5,000, the Panel shall consist of one such person unless the Secretary directs otherwise: Provided, however, if the customer in an arbitration under Section 2(a) of this Code so requests in the Demand for Arbitration (see Section 6(c) of this Code), the Chairman and at least one other member of the Panel, and the Panel member where there is a single-member Panel, shall not be connected with an NFA Member or NFA (except as NFA arbitrators).

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Section 6. Initiation of Arbitration.

* * *

(c) Demand for Arbitration.

If such person wishes to proceed with the arbitration, such person, within [30] 35 days after the date of transmittal by the Secretary under (b) above, shall return the completed Demand for Arbitration to the Secretary together with the appropriate fee (see Section 11 below) and, in an arbitration under Section 2(a)(1)(ii) or 2(b) above, a copy of the agreement to arbitrate. The Secretary shall promptly review each Demand for Arbitration for completeness. Any Demand for Arbitration which the Secretary deems to be incomplete, or which is not accompanied

by the appropriate fee, shall be returned by registered mail. In that event, such person shall submit a completed Demand for Arbitration, together with any unpaid fee, within [15] 20 days following [return] transmittal by the Secretary. The Secretary shall reject any Demand for Arbitration which has not been timely filed, or for which the appropriate fee has not been paid.

* * *

(e) Answer.

The respondent shall submit an answer to the Secretary within [40] 45 days from the date of transmittal of the Demand for Arbitration to the respondent. The respondent shall concurrently provide a copy of the answer to the claimant. An allegation in the Demand for Arbitration that is not denied in the answer shall be deemed by the Panel to be admitted.

(f) Section 2(a)(2) Counterclaim.

Any counterclaim under Section 2(a)(2) must be asserted in the answer, unless the claimant consents to a later assertion of the counterclaim. If any counterclaim is asserted, the party asserting the counterclaim shall promptly remit the appropriate fee to the Secretary (see Section 11 below). The person against whom the counterclaim is asserted shall answer the counterclaim by submitting a reply to the Secretary, within [30] 35 days after the date of the answer or later assertion of the counterclaim, and concurrently shall provide a copy to the counterclaiming respondent. Any allegation in the counterclaim that is not denied in the reply shall be deemed by the Panel to be admitted. The Secretary shall reject any counterclaim which has not been timely filed, or for which the appropriate fee has not been paid.

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(i) Computation of Time.

(1) For purposes of satisfying the timeliness requirements of Sections 6(c), 6(e) and 6(f), transmittal shall be deemed to occur on the earlier of the date that documents are mailed by NFA or the date that documents are delivered by NFA and submission or return to NFA shall be deemed to occur on the earlier of the

date that documents are mailed to NFA as evidenced by postmark or affidavit of service, or the date delivered to NFA.

(2) The counting of days shall include all calendar days and, should a due date fall on a weekend or legal holiday, such due date will be computed as the next business day on which mail is delivered.

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Section 9. Hearing.

(f) Summary Proceeding.

Where the aggregate amount of the customer's claims [(including interest)] (exclusive of interest and costs) plus the aggregate amount of counterclaims [(including interest)] (exclusive of interest and costs) is under $2500 the proceeding shall be conducted entirely through written submissions unless the Secretary directs otherwise.

F. Proposed Guideline for the Disclosure by FCMs and IBs of Costs Associated with Futures Transactions.

GUIDELINE FOR THE
DISCLOSURE BY FCMs AND IBs OF
COSTS ASSOCIATED WITH
FUTURES TRANSACTIONS

National Futures Association ("NFA") Compliance Rule 2-4 provides that "Members and Associates shall observe high standards of commercial honor and just and equitable principles of trade in the conduct of their commodity futures business." NFA Compliance Rule 2-4 requires that each FCM Member, or in the case of introduced accounts, the Member introducing the account make available to its customers, prior to the commencement of trading, information concerning the costs associated with futures transactions.*

If fees and charges associated with futures transactions are not determined on a per trade or round-turn trade

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* NFA Bylaws define "futures" to include domestic exchange traded options and dealer options. See NFA Compliance Rule 1-1(g).

basis, the Member must provide the customer with a complete written explanation of such fees and charges, including a reasonable example or examples of such fees and charges on a per trade or round-turn trade basis. Where the per trade or round-turn trade equivalent of the fees or charges may vary widely the most appropriate disclosure would be to explain this fact and to provide examples demonstrating the reasonably expected range of the fees or charges. This additional disclosure is not required if:

1) the customer has been given a Disclosure Document required by NFA Compliance Rule 2-13 and CFTC Part 4 Regulations;

2) the customer is an NFA Member;

3) the customer has privileges of membership on a contract market; or

4) the customer is not an individual.

To further ensure that information concerning fees and charges has been made available to customers, FCM Members must provide customers with purchase and sale or confirmation statements which include a reasonable breakdown of all fees and charges assessed in connection with all transactions. NFA assessment fees must either be separately itemized from commissions or, if they are included among other fees (such as exchange fees), the customer must be given notice at some time of the amount of the NFA assessment fee.

NFA recognizes that FCM and IB Members may employ various arrangements in assessing fees and charges associated with futures transactions to customers. It is NFA's position that any such arrangement which is intended to or is likely to deceive customers is a violation of NFA Requirements and will subject the Member to disciplinary action.

II. EXPLANATION OF AMENDMENTS, RULE AND GUIDELINE

A. Explanation of Amendments to NFA Bylaw 301(a)(i), 301(h) and 301(j).

There are several ways in which a person's membership or associate membership can terminate under NFA Bylaws. As currently drafted, these methods of termination appear in various

sections of the Bylaws. The main purpose of the proposed amendments to Bylaw 301 is to consolidate NFA's rules regarding termination into one section.

In addition to consolidating the rules governing termination, the proposed amendments clarify when and how the membership of a Member or Associate will terminate in two situations. First, the proposed amendment to Bylaw 301(h)(i) specifies that the membership of any person who is a Member or Associate solely by virtue of having been granted a temporary license ("TL") shall automatically terminate should NFA terminate the TL. Second, NFA has attempted to clarify the termination procedures in the situation where a Member withdraws or fails to renew all registrations. The proposed amendment to Bylaw 301(h)(ii) provides that if a Member withdraws or fails to renew all registrations, then that person's membership may be summarily terminated by order of the President. This amendment merely makes explicit NFA's current practice of granting lapsed registrants a grace period prior to terminating their membership.

B. Explanation of Proposed Amendment to NFA Bylaw 305 Schedule A Section I(f).

The Futures Trading Act of 1982 ("Act") amended the registration provisions of the Commodity Exchange Act and authorized the CFTC to grant temporary licenses to qualified applicants for a period not to exceed six months. Up to the present time, the CFTC has chosen to make temporary licenses available only to applicants seeking registration as Associated Persons ("APs"). NFA believes that guaranteed Introducing Brokers ("IBs") are analagous to sponsored APs and should also enjoy the benefits of temporary licensing. The proposed amendment to Bylaw 305, if approved by the CFTC, would allow NFA to extend temporary licenses to guaranteed IBs. If approved, the proposed amendment would not become effective until NFA's registration systems could be adapted to accommodate the amendment.

C. Explanation of Proposed Amendment to NFA Bylaw 703 establishing three-year terms for Advisory Committee members.

Under NFA Bylaw 703 the Board of Directors can appoint advisory committees to advise the Board. Currently, NFA has four such Committees. Three of these committees advise the Board on matters relating to the FCM, IB and CPO/CTA categories

of membership. The fourth advisory committee deals with issues relating to proficiency testing and educational matters.

The Bylaws establish three-year terms for members serving on the Membership Committee, the Appeals Committee and the Business Conduct Committees. The proposed amendment establishes three-year terms for Advisory Committee members with the provision that terms initially established be staggered.

D. Explanation of Compliance Rule 2-30, Customer Information and Risk Disclosure.

A section-by-section analysis of Rule 2-30, which was also approved by the Board of Directors at its recent meeting, is contained in the Interpretive Notice to Members, a copy of which is enclosed.

E. Explanation of Proposed Amendments to NFA's Code of Arbitration Sections 4, 6 and 9.

In its Initial Report on NFA's Arbitration Program dated March 22, 1985, the Division of Trading and Markets ("the Division") recommended that NFA clarify certain sections of the Code of Arbitration ("the Code") that do not conform to the program's internal procedures. The proposed amendment to Section 6 of the Code responds to the Division's recommendation by making explicit in the Code NFA's internal procedures for computing time for purposes of determining the timely submission of documents to NFA.

Additionally, the proposed amendments to Sections 4 and 9 of the Code make uniform the basis for determining the size of an arbitration panel, the availability of a summary proceeding and the appropriate case filing fee. In all three instances, the dollar amount of the claim will be considered exclusive of interest and costs.

F. Explanation of Proposed Guideline for the Disclosure by FCMs and IBs of Costs Associated with Futures Transactions.

NFA's Board of Directors adopted this Guideline as an interpretation of NFA Compliance Rule 2-4, pursuant to the Board's authority to interpret NFA requirements under NFA Bylaw 511. NFA Compliance Rule 2-4 provides that "Members and Asso-

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ciates shall observe high standards of commercial honor and just and equitable principles of trade in the conduct of their commodity futures business."

The Guideline requires that all FCM and IB Members and their Associates make available to their customers information concerning the costs associated with futures trading. The Guideline also requires that all FCM Members provide customers with either a purchase and sale statement or a confirmation statement containing a reasonable breakdown of all fees and charges assessed in connection with all transactions.

The Guideline calls for additional written disclosure to be made, prior to trading, if the FCM or IB assesses fees and charges in a manner other than on a per-trade or round-turn basis. The FCM or IB must provide the customer with a complete written explanation of such fees and charges, including reasonable examples of such fees on a per trade basis. The Guideline states that where the per-trade equivalent may vary widely based on the number of trades that are made, the most appropriate disclosure would be to use examples which demonstrate the reasonably expected range of the per-trade equivalent of the fees or charges. The Guideline provides exemption from this additional written disclosure if the customer has received a Disclosure Document from a CPO or CTA required by CFTC Part 4 Regulations, is an NFA Member, has privileges of membership on a contract market, or is not an individual.

NFA respectfully requests that the amendments to NFA Bylaws 301 and 703 and NFA Code of Arbitration Sections 4, 6 and 9 be declared effective upon approval by the Commission. With respect to Compliance Rule 2-30 and the Guideline, NFA intends to make these effective six months after adoption or upon approval by the Commission, whichever is later. With respect to the amendments to NFA Bylaw 305, NFA intends to make these effective when NFA's registration systems have the capability to accommodate the amendments.

Sincerely,

Joseph H. Harrison, Jr.
General Counsel

JHH:cm(D13/F11)
Enclosure

cc: Commission Chairman, Commissioners and Division Directors

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

December 2, 1985

National Futures Association

Compliance Rule 2-30: Customer Information and Risk Disclosure

INTERPRETIVE NOTICE

NFA Compliance Rule 2-4 requires Members to observe high standards of commercial honor and just and equitable principles of trade in the conduct of their futures business. NFA's FCM Advisory Committee ("the Committee") has been considering ways in which the general standard of Rule 2-4 can be further defined in order to develop uniform industry-wide standards which will offer guidance to the Members. In the course of its work the Committee noted the increasing level of commentary, in public and regulatory forums, on the absence of a "know your customer" or "suitability" rule in the futures industry and a perception on the part of some that there is a concomittant lack of protection for futures customers. NFA's Executive Committee also became aware of these comments and asked the Committee to study the matter and make appropriate recommendations. Based on its knowledge and experience in the industry, the Committee believed that any careful consideration of this issue would have to take into account the important role that risk disclosure plays whenever a customer opens a futures account or selects a commodity trading advisor, and the extent to which futures professionals were already obtaining information about their customers.

To learn more about the current level of inquiry conducted through the new account opening procedures now being used in the industry, NFA sent a questionnaire to all of its Members. The Committee also reviewed research on the evolution of the suitability and "know your customer" doctrines in the securities industry and noted that although there are several different formulations of the rule, all are based on the same premise: that different types of securities can have widely varying degrees of risk potential and serve very different investment objectives. For that reason, the securities suitability rules are cast in terms of the suitability of a particular transaction.

The Committee noted that the futures industry differs from the securities industry in several crucial ways. Most importantly, futures contracts in general are recognized as highly volatile instruments. It therefore makes little sense to presume that a certain futures trade may be appropriate for a customer while others are not. An appreciation of the risks of futures trading must be gained and a determination of its appropriateness made at the time each customer makes a decision

to trade futures in the first place. This is true regardless of whether the customer will rely on recommendations by futures professionals or the customer will make his or her own trading decisions.

The futures industry has traditionally met this need through risk disclosure designed to encourage the customer to make an informed decision as to whether futures trading is suitable for that customer. The Risk Disclosure Statement and the Options Disclosure Statement mandated by CFTC Regulations 1.55 and 33.7, respectively, and the Disclosure Document required by the CFTC Part 4 Regulations each are designed to bring the suitability issue to the customer's attention.*

In the specific area of exchange traded options, the CFTC has previously noted the importance of risk disclosure and the need for the futures professional to learn enough about the customer in order to provide risk disclosure. When the Options Disclosure Statement requirement was enacted in 1981 as part of the options pilot program, the CFTC stated in its Federal Register release (46 Fed. Reg. 54500 [1980-82 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶21,263) that:

> ". . . the FCM must acquaint itself sufficiently with the personal circumstances of each option customer to determine what further facts, explanations and disclosures are needed in order for that particular option customer to make an informed decision whether to trade options. . . . While this requirement is not a "suitability" rule as such rules have been composed in the securities industry, before the opening of an option account the FCM has a duty to acquaint itself with the personal circumstances of an option customer."

The CFTC went on to state that "the extent of the inquiry should be left to the prudent judgment of the FCM."

NFA was concerned that allowing suitability or know your customer standards to develop outside of the self-regulatory framework carried with it the possibility that a poorly

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* The risk disclosure statements required by CFTC Regulations 1.55 and 4.31 direct the customer to "carefully consider whether [futures] trading is suitable for you in light of your financial condition"; the one required by CFTC Regulation 33.7 informs the customer that "commodity option transactions are not suitable for many members of the public."

defined or inappropriate duty would be fashioned on a case-by-case basis, perhaps by ill-considered analogy to the securities industry rules. Because NFA construes its rules on a case-by-case basis through the decisions of the Business Conduct Committees ("BCCs") which are composed of informed futures professionals, NFA is uniquely positioned to set an ethical business standard which will be construed by Members evaluating the conduct of other Members.

The Committee determined that the exchange of information between a new customer and a futures professional -- the customer providing personal data and the Member providing disclosure about the risks of futures trading -- was the focal point around which to structure a sound customer protection rule. On August 9, 1985, the Committee released for public comment a Proposed Rule on Customer Information and Risk Disclosure. The comments received were considered in the drafting of the Rule in final form, and Rule 2-30 was adopted by NFA's Board on November 21, 1985.

When the CFTC declined in 1978 to adopt a "suitability" rule, after releasing a proposed rule for comment, it stated that it was unable "to formulate meaningful standards of universal application." 43 F.R. 31886, [1977-1979 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 20,642. NFA found the same difficulty, and for that reason the Rule is premised on NFA's conclusion that the customer is in the best position to determine the suitability of futures trading if the customer receives an understandable disclosure of risks from a futures professional who "knows the customer." NFA believes that the approach taken in Rule 2-30 is preferable to one which would erect an inflexible standard that would bar some persons from using the futures markets.

SECTION-BY-SECTION ANALYSIS

Section (a): General Rule

Rule 2-30 is intended to define "high standards of commercial honor and just and equitable principles of trade" as applied to a Member's procedures for exchanging information with new futures customers at the time they become customers.* Section (a) sets forth the basic requirement: obtain information and provide risk disclosure which includes the disclosures required by the Rule plus, in some cases, additional disclosure. Rule 2-30 is a "know your customer" rule; however,

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* NFA Bylaws define "futures" to include domestic exchange traded options and dealer options. See Compliance Rule 1-1(g).

it does not require the Member or Associate to make the final determination that a customer should be barred from futures trading on suitability grounds. Some "know your customer" rules in the securities industry (New York Stock Exchange Rule 405, for example) have been construed in that manner; these interpretations do not apply to Rule 2-30.

NFA's enactment of the Rule 2-30 should not be construed to expose Members to increased potential liability for damages in customer litigation or reparation proceedings, for several reasons. First, a business conduct standard promulgated by a self-regulatory organization does not create a private cause of action. Furthermore, Rule 2-30 is not an anti-fraud rule. In order to prove a violation, there is no requirement to prove any intent on the part of the Member to deceive. Therefore, evidence of a violation of Rule 2-30 would not in and of itself constitute evidence of a violation of any anti-fraud rule or statute. Finally, to the extent that personal information about a customer is germane to the issues in a reparations or arbitration case, it is undoubtedly already being considered even in the absence of a formal rule requiring Members to obtain it.

Section (a) provides that the Rule applies only to customers who are individuals; this includes individuals who open accounts jointly with others. Although accounts opened by business entities such as corporations and partnerships present other concerns (such as compliance with NFA Bylaw 1101, which prohibits Members from transacting customer business with non-Members who are required to be registered), the scope of Rule 2-30 is limited to natural persons, who may lack the sophistication of institutional customers.

Section (b): New Customers

The Member's obligation to obtain information and provide risk disclosure under the Rule is limited to the first time the customer establishes a futures account with the Member. This limitation was the result of the balancing of the benefits of repeated information exchange against the burden of imposing additional requirements on the already extensive account-opening procedures for subsequent accounts for the same customer.*

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* Certain CFTC Regulations and NFA Requirements will apply with respect to each account or interest entered into; the discussion above refers to those aspects of Rule 2-30 which are additional requirements. See Section (i) of the Rule.

Section (c): Information To Be Obtained

Item (1) is essentially the information required by CFTC Regulation 1.37(a), which applies to FCMs and IBs. Item (2) includes estimated annual income and net worth, information which the Committee found is commonly sought from new customers. Item (3), the customer's age, is also a commonly sought item which the Committee thought would be helpful in putting the customer's financial condition, ability to understand and level of sophistication into perspective for the Member. Most Members responding to the questionnaire indicated that they require information about previous futures trading experience; a smaller number responded that they ask about securities or options trading experience. NFA believes that experience with these types of investments may be relevant and has therefore included it.

Information on age, estimated annual income and net worth may be obtained through the use of brackets or "in excess of" descriptions so long as these are reasonably designed to elicit the required information in a meaningful manner.

The information specified in Section (c) is a minimum requirement, intended to serve as a core of basic information that should always be obtained. Some Members routinely elicit additional items, such as liquid net worth, risk capital, or number of dependents, which may be quite useful, and NFA received comments on the Rule when it was drafted suggesting that these items be required by the Rule. NFA concluded, however, that the better approach was to adopt a Rule that would specify the minimum required information and allow Members to obtain other information as they deemed appropriate.

Section (d): Risk Disclosure

The risk disclosures incorporated into this section are required by CFTC Regulations. (There are other disclosures required by CFTC Regulations, such as the Regulation 32.5 dealer options disclosure statement and the Regulation 190.10(c) disclosure statement for non-cash margin, which may apply for particular accounts.) These disclosures are only the minimum required. NFA believes that the decision with respect to what additional disclosure, if any, should be given to the customer is best left to the Member, whose conduct is subject to review by the BCCs. There may be some customers for whom the additional disclosure will portray futures trading as too risky for that customer. However, NFA believes that a determination of who those customers are cannot be made except on a case-by-case basis, because no objective criteria can be established that will apply to all customers. The essential feature of the Rule is the link between "knowing the customer" and providing risk disclosure. Once that has been done, the customer is free to make the decision whether to trade futures.

Section (e): Introduced and Third-Party Controller Accounts

The purpose of this section is to place the obligation to obtain information and provide risk disclosure on the Member who deals directly with the customer when an account is introduced to a carrying FCM by an IB or another FCM doing business on a fully disclosed basis, or when a CTA controls the trading in a customer's account pursuant to written authorization. NFA believes that the Member or Associate who solicits the customer and communicates with the customer in the process of the account opening is the appropriate party to comply with the Rule. In some cases, this may be the Member introducing or controlling the account; in other cases, it may be the carrying FCM.

Of course, each Member remains responsible for compliance with all applicable CFTC Regulations and NFA Requirements. For example, an FCM (or, in the case of an introduced account, the IB) must furnish a Regulation 1.55 Risk Disclosure Statement to each customer, including those whose accounts were solicited by and will be traded by CTAs. Similarly, a CTA must deliver a Disclosure Document to each customer, including those who were solicited by the FCM. Section (i), which is discussed below, clarifies each Member's obligation to comply with other requirements.

Section (f): Reliance on the Customer as the Source of the Information

Some Members confirm financial data because of concern about the creditworthiness of the customer. NFA believes, however, that the decision whether to confirm customer data is best left to the Member's sound business judgment and is irrelevant to a customer protection rule aimed at providing information to a customer.

Rule 2-30 contemplates a good faith exchange of information between the customer and the Member or Associate. A customer who gives incorrect information would still receive all the required risk disclosure statements but would have impaired the Member's ability to consider fully the customer's ability to understand the risk disclosures or whether additional disclosure was necessary. However, Section (f) will not operate as a "safe harbor" for a Member or Associate who falsifies information or who induces or suggests falsification by the customer. Information invented by the Member or Associate does not constitute "information about the customer" as required by the general rule. Members and Associates engaging in such conduct will be subject to appropriate disciplinary action.

Section (g): Recordkeeping; Customers Who Decline to Provide Information

In order to allow NFA to audit for compliance with the Rule, Section (g) requires that a timely record be made

or obtained which contains the information obtained from the customer. Customers who decline to provide information (beyond that required by CFTC Regulation 1.37(a), which must always be obtained) may still open accounts, but NFA would expect Members to take appropriate action upon learning that an inordinate number of a particular Associate's customers apparently "decline" to provide basic information. Because Section (a) imposes an affirmative duty on Members to obtain information, a Member who engages in (or allows Associates to engage in) a course of conduct which is designed to or has the effect of eliciting or prompting refusals by customers to provide that information would not have discharged that duty and could not use Section (g) as a shield from disciplinary action.

The approval requirement has been broadened to apply to all new accounts. This is consistent with the Member's responsibility to supervise the futures activities of its employees diligently pursuant to NFA Compliance Rule 2-9.

In the case of non-U.S. customers (those who neither reside in nor are citizens of the United States) a record that the customer declined to provide the information need not be made.

Section (h): Review Procedures

The requirement that a Member establish adequate review and compliance procedures provides Members with the flexibility to design procedures that are tailored to the way the Member does business. NFA's audit staff will, in the routine course of an examination, check these procedures for adequacy, taking into account the facts and circumstances of the particular Member.

Section (i): Relationship to Other Requirements

Rule 2-30 incorporates certain CFTC Regulations but its requirements are in addition to any imposed by those Regulations or other NFA Requirements. For example, the Rule requires a CTA to provide a Disclosure Document, if required to do so by CFTC Regulation 4.31, at the time a customer first authorizes the Member to direct trading in a futures account for the customer. This is because Rule 2-30 is intended to apply to "account opening" or its equivalent. However, CFTC Regulation 4.31 requires that the Disclosure Document be delivered at the time of solicitation. Other examples of CFTC Regulations which affect the process covered by the Rule have been cited in the discussion of Sections (b), (d), (e) and (g) above. Section (i) serves to clarify the ongoing obligation of Members to comply with all CFTC Regulations and NFA Requirements.

cm(D6/F14,15)

COMMODITY FUTURES TRADING COMMISSION
2033 K STREET, N.W., WASHINGTON, D.C. 20581

DIVISION OF
TRADING AND MARKETS

XC: ATTORNEYS

January 7, 1986

Joseph H. Harrison, Jr.
General Counsel and Secretary
National Futures Association
200 West Madison Street
Chicago, Illinois 60606

Re: Proposed Amendments to Bylaws 301(a)(i), 301(h), 301(j), 305 Schedule A Section I(f) and 703; Proposed Compliance Rule 2-30; Proposed Amendments to Code of Arbitration Sections 4, 6 and 9; and Proposed Guideline for the Disclosure by FCMs and IBs of Costs Associated with Futures Transactions.

Dear Mr. Harrison:

By letter dated December 3, 1985, and received by the Commission on December 9, NFA submitted the captioned rule proposals for Commission review and approval. This is to advise you, in accordance with the provisions of Section 17(j) of the Act, that the Commission will not complete the review of that submission within thirty days of its receipt. The Division is continuing to evaluate those proposals and will contact you shortly if any additional information is needed to assist that review. If you have any questions, please call Kenneth M. Rosenzweig or Linda Kurjan.

Very truly yours,

Andrea M. Corcoran
Director

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GENERAL COUNSEL'S OFFICE

UNITED STATES OF AMERICA
COMMODITY FUTURES TRADING COMMISSION
2033 K Street, N.W.
Washington, D.C. 20581

January 29, 1986

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RECORDS
GENERAL COUNSEL'S OFFICE

Joseph H. Harrison, Jr., Esq.
General Counsel
National Futures Association
200 West Madison Street
Chicago, Illinois 60606

Re: NFA Amendments to Bylaws 301(a)(i), 301(h), 301(j) and 703, and to Code of Arbitration Sections 4(a), 6(c), 6(e), 6(f), 6(i) and 9(f)

Dear Mr. Harrison:

This is to inform the National Futures Association that on January 28, 1986, the Commission approved the captioned NFA rule amendments. Those rule changes relate to NFA membership termination, the terms of persons serving on NFA's advisory committees, and the computation of time and claim amounts for purposes of arbitration procedures. The proposals were submitted for Commission review and approval pursuant to Section 17(j) of the Commodity Exchange Act by your letter dated December 3, 1985, which was received by the Commission on December 9.

That submission also contained proposals for (1) a "know-your-customer" rule, (2) a guideline on the disclosure of fees by futures commission merchants and introducing brokers, and (3) procedures to govern the temporary licensing of applicants for registration as guaranteed introducing brokers. Be advised that those three proposals are continuing to undergo Commission review.

Very truly yours,

Jean A. Webb

Jean A. Webb
Secretary of the Commission

COMMODITY FUTURES TRADING COMMISSION
2033 K STREET, N.W., WASHINGTON, D.C. 20581

DIVISION OF
TRADING AND MARKETS

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GENERAL COUNSEL'S OFFICE

February 10, 1986

Joseph H. Harrison, Esq.
General Counsel
National Futures Association
200 West Madison Street
Chicago, Illinois 60606

Re: Temporary Licenses for Guaranteed Introducing Brokers

Dear Mr. Harrison:

By letter dated December 3, 1985, the National Futures Association ("NFA"), pursuant to section 17(j) of the Commodity Exchange Act ("Act"), submitted for review and approval of the Commodity Futures Trading Commission ("Commission") proposed amendments to Bylaw 305, Schedule A, Section 1(f). The proposed amendments would authorize NFA to issue a temporary license to an apparently qualified applicant for registration as an introducing broker that has entered into a guarantee agreement with a futures commission merchant in accordance with the provisions of Commission rule 1.10(j), 17 C.F.R. §1.10(j) (1985). The requirements that an applicant would have to meet to be issued a temporary license are essentially those which presently govern temporary licenses for associated person applicants under Commission rules 3.40-3.43.

As you know, when the Commission adopted its temporary license regulations, it determined to limit its authority in this regard to applicants for registration as an associated person. Specifically, the Commission stated:

> [T]he granting of a temporary license is particularly appropriate for an applicant for registration as an AP because such an applicant must be sponsored by another registrant which must conduct a preliminary fitness check of the applicant and must directly supervise the applicant's conduct.

49 Fed. Reg. 8209 (March 5, 1984).

With respect to other categories of registrant, the Commission stated:

> In contrast, other registrants are not subject to such scrutiny or direct supervision. In addition, the Commission is concerned that if a temporary license were granted to applicants other than APs, the applicant would be able to commence business, hire employees and, in the case of an FCM, accept customer funds subject to a subsequent determination by either

> the Commission or the NFA to deny registration. The Commission, therefore, concludes that the potential disruptions to both customers and employees which might result from interrupting an ongoing business outweigh the benefits which might be achieved by extending the applicability of the temporary licensing provisions to such applicants.

Id.

Before the Division of Trading and Markets ("Division") is able to consider whether to recommend approval or disapproval of the proposed rule, NFA must provide the Division with information sufficient for it to conclude that the concerns expressed by the Commission above are not applicable in the case of a guaranteed introducing broker. For example, although an FCM that guarantees an introducing broker is liable for the obligations of that introducing broker under the Act and the regulations thereunder, the FCM is not required to conduct a preliminary fitness examination of the applicant and its principals, nor must the FCM directly supervise the applicant's conduct. Therefore, the Division requests NFA to address these issues specifically and, in this connection, consider whether NFA would be prepared to adopt rules to require FCMs to perform such fitness examinations and direct supervision. In addition, NFA should address why the benefits that may be achieved by extending the applicability of temporary licensing to guaranteed introducing brokers outweigh the potential disruptions to both customers and employees that may result from the interruption of an ongoing business to which the Commission referred.

Any additional information that NFA believes would assist the Division in its review of this proposed amendment will, of course, be welcome. If you have any questions, please feel free to contact Linda Kurjan, Special Counsel, at 202/254-8955.

Very truly yours,

Andrea M. Corcoran
Director

UNITED STATES OF AMERICA
COMMODITY FUTURES TRADING COMMISSION
2033 K Street, N.W.
Washington, D.C. 20581

April 3, 1986

Joseph H. Harrison, Jr., Esq.
General Counsel
National Futures Association
200 West Madison Street
Chicago, Illinois 60606

Re: National Futures Association Guideline under Compliance Rule 2-4 for Disclosure by FCMs and IBs of Costs Associated with Futures Transactions

Dear Mr. Harrison:

This is to inform the National Futures Association that the Commission, at its open meeting on April 2, 1986, approved the captioned NFA Guideline. The rule proposal had been submitted for Commission review and approval pursuant to Section 17(j) of the Commodity Exchange Act by a letter from you dated December 3, 1985. The Commission notes that although the Guideline does not explicitly require routine disclosure of commissions and fees, Commission Regulations 32.5(c) and 33.7(d), incorporated by reference in NFA Compliance Rules 2-25 and 2-19, respectively, require every person soliciting or accepting an order for any dealer or exchange-traded option transaction to inform the customer, prior to the entry of the transaction, of the amount of the premium and any mark-up thereon, fees, commissions, costs and other charges to be incurred in connection with the transaction.

Very truly yours,

Jean A. Webb

Jean A. Webb
Secretary of the Commission

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GENERAL COUNSEL'S OFFICE

UNITED STATES OF AMERICA

COMMODITY FUTURES TRADING COMMISSION

2033 K Street, N.W.
Washington, D.C. 20581

April 3, 1986

Joseph H. Harrison, Jr., Esq.
General Counsel
National Futures Association
200 West Madison Street
Chicago, Illinois 60606

Re: National Futures Association Compliance Rule 2-30

Dear Mr. Harrison:

This is to inform the National Futures Association that the Commission, at its open meeting on April 2, 1986, approved NFA Compliance Rule 2-30, "Customer Information and Risk Disclosure." The rule proposal had been submitted for Commission review and approval pursuant to Section 17(j) of the Commodity Exchange Act by a letter from you dated December 3, 1985. The Commission notes that, consistent with Commission Regulation 1.55(d), NFA Rule 2-30 "does not relieve a futures commission merchant or introducing broker from any other disclosure obligation it may have under applicable law."

Very truly yours,

Jean A. Webb

Jean A. Webb
Secretary of the Commission

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GENERAL COUNSEL'S OFFICE

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

April 23, 1986

Andrea M. Corcoran, Esq.
Director, Division of Trading &
Markets
Commodity Futures Trading Commission
2033 K. Street, N.W.
Washington, D.C. 20581

Re: **Temporary Licenses for Guaranteed Introducing Brokers**

Dear Ms. Corcoran:

This letter is in response to your letter dated February 10, 1986, which indicated that the Division of Trading and Markets ("Division") would require further information from National Futures Association ("NFA") to enable the Division to recommend the approval of NFA's proposed amendments to Bylaw 305, Schedule A, Section 1(f) (Temporary Licenses for Guaranteed Introducing Brokers). Specifically, the Division was interested in knowing why NFA believed that the applicability of temporary licensing should be extended to guaranteed introducing brokers ("IBs") in light of the Division's view that futures commission merchants ("FCMs") are not required to conduct a preliminary fitness examination of the IB applicants that they guarantee; and that FCMs are not required to supervise the conduct of IB applicants that they guarantee. In this connection, the Division questioned whether NFA would be prepared to adopt rules to require FCMs to perform both of these activities. Additionally, the Division was interested in knowing how NFA believed that the benefits that would be achieved by extending the applicability of temporary licensing to guaranteed IBs would outweigh the potential disruptions to both customers and employees of the IB that may result from interruption of business if the temporarily licensed IB was determined unfit for registration.

NFA addressed these Commission concerns in the early stages of its consideration of a rule allowing for the temporary licensing of guaranteed IBs. It was only after NFA was sufficiently convinced that these concerns could be satisfied that NFA was prepared to forward a rule to the Commission for the Commission's review and approval. NFA believes that the aforementioned Division concerns are minimized to the extent that they should not prevent the Commission from acting favorably on NFA's proposed rule because: (1) existing Commission regulations and NFA rules provide sufficient assurance that a guarantor FCM will subject a potential guaranteed IB to a preliminary background check that would at least equal the scope of the

preliminary background check required of sponsors of applicants seeking registration as associated persons ("APs"); (2) NFA Compliance Rule 2-9 requires a guarantor FCM to directly supervise the conduct of its guaranteed IBs; and (3) the benefits of extending temporary licenses to guaranteed IBs outweigh any disruption to customers or employees of the IB that may result from interruptions of business if the temporarily licensed IB is determined unfit for registration.

I. **Existing Commission regulations and NFA rules provide sufficient assurance that a guarantor FCM will subject a potential guaranteed IB to a preliminary background examination.**

NFA believes that a guarantee agreement entered into by an FCM and an IB is analagous to AP sponsorship. The purpose of a guarantee agreement is to enable the IB to meet the alternative adjusted net capital requirement and to protect the customers of the IB. A guarantee agreement provides that the FCM which is a party thereto guarantees performance by the IB of, and becomes jointly and severally liable for, all obligations of the IB under the Act, as it may be amended from time to time, and the rules, regulations and orders which have been or may be promulgated thereunder with respect to the solicitation of and transactions involving all customer and option customer accounts of the IB entered into on or after the effective date of the agreement.

Given the potential liability for damages of an FCM that is party to a guarantee agreement, NFA believes that it can be reasonably expected that an FCM will subject its potential guaranteed IBs to a close preliminary background examination. NFA also believes that the preliminary background examination that would be conducted by an FCM would at least equal the scope of the preliminary background check that is required of registrants that sponsor applicants for registration as APs under current Commission regulations.

The motivation to make a thorough background check is further strengthened by the fact that NFA Compliance Rule 2-23 makes the liability of the guarantor Member FCM clear in a disciplinary context: "Any Member FCM which enters into a guarantee agreement, pursuant to CFTC Regulation 1.10(j), with a Member IB, shall be jointly and severally subject to discipline under NFA Compliance Rules for acts and omissions of the Member IB which violate NFA require-

ments occurring during the term of the guarantee agreement."

The FCM has no safe harbor to avoid either civil or disciplinary liability for the acts of its guaranteed IBs. In this circumstance it cannot be doubted that an FCM qualified to act as a guarantor will take the same care in selecting guaranteed IBs as it would in similar matters of interest to its business. While these steps may not be formalized in a rule, the steps which are formalized with respect to APs are not actually very extensive and are not likely to exceed in thoroughness those chosen as a matter of essential business judgment.

Commission Regulations 3.12(c)(1)(ii) and 3.16(c)(1)(ii) require that sponsors of applicants for registration as APs certify that they have "verified the information supplied by the applicant in response to the questions on Form 8-R which relate to the applicant's education and employment history during the preceeding five years." These regulations do not outline any particular procedures that must be followed by a sponsor to satisfy the background verification requirement. While such formal steps would give the sponsor comfort about where the AP worked and went to school, it does not necessarily contribute to an understanding of fitness beyond giving some evidence of the APs general tendency toward veracity. The regulations simply do not require a sponsor to conduct a fitness check of the applicant -- to undertake an FBI fingerprint check and an SEC name check of the applicant or to examine the applicant's reputation or character. Rather, these Commission regulations set out the minimum background check that a sponsor exercising reasonable business judgment would undertake of a potential employee whose conduct it will be responsible for.

Given the potential liability of the guarantor FCM for the breaches of its guaranteed IBs, NFA believes that it is reasonable to expect that an FCM will conduct more than this minimal background verification with respect to its potential guaranteed IBs.

II. NFA Compliance Rule 2-9 requires a guarantor FCM to supervise the conduct of its guaranteed IBs.

NFA believes that a guarantor FCM would supervise the activities of its guaranteed IBs given the potential liability

of the FCM under the guarantee agreement. NFA Compliance Rule 2-9, however, makes this duty of a guarantor FCM explicit.

NFA Compliance Rule 2-9 requires that, "Each Member shall diligently supervise its employees and agents in the conduct of their commodity futures activities for or on behalf of the Member." With a guaranteed IB in the position of "agent" to its guarantor FCM, NFA believes that no NFA rule could be clearer in indicating the duty of a guarantor FCM to supervise the activities of its guaranteed IBs.

III. The benefits of extending temporary licenses to guaranteed IBs outweight the potential costs.

A. Benefits to guaranteed IBs would be commensurate with those realized by APs.

NFA believes that the benefits that would result to guaranteed IBs by extending the applicability of temporary licensing to such registrants are commensurate with those that the Commission has chosen to extend to APs. In proposing its rules providing for the temporary licensing of APs on November 2, 1983, the Commission stated:

> By its very nature, the making of a full fitness check can be time consuming. Generally, a minimum of 8 to 10 weeks are required to process an application for registration as an associated person ("AP") even if the applicant, on the basis of the application itself, which includes a sponsor's certification as to fitness, does not appear to be unfit for registration. Because an applicant may not act in any capacity requiring registration during this fitness review period, certain hardships may be imposed on firms and, in particular, individuals seeking to enter the futures industry.

(1982-1984 Transfer Binder) Comm. Fut. L. Rep. (CCH) ¶ 21,885 at 27,765 (November 2, 1983).

While the apparent benefit realized by AP applicants in being extended temporary licenses is that such applicants no longer encounter the aforementioned

eight to ten week wait to enter the futures industry, the less apparent benefit is that the same applicants are no longer required to experience a period of forced idleness during that waiting period.

Commission regulations 3.12(c)(1) and 3.16(c)(1) require applicants for AP registration to obtain the sponsorship of a registrant prior to submitting their registration applications. The regulations thus require that an AP applicant expend the time and effort necessary to convince a registrant that the applicant is worthy of the registrant's sponsorship. In most instances AP applicants are forced to relinquish their pre-registration employment to do so. As a result, prior to being extended the benefits of temporary licenses, many AP applicants were not only prevented from entering the futures industry for at least eight to ten weeks pending the outcome of their fitness review, but many awaited entrance into the futures industry in an idle and unemployed capacity.

NFA believes that applicants seeking registration as guaranteed IBs are analagous to persons seeking registration as APs with respect to this period of forced idleness. Commission regulation 3.15(a)(1) requires an applicant seeking registration as a guaranteed IB to enter into a guarantee agreement with an FCM prior to filing his registration application. From a practical standpoint, in order for an IB applicant to be extended a guarantee agreement by an FCM, the IB applicant must exhibit to the FCM that it has established a business plan and that it has taken steps to put such business into place. Establishing a business plan and the contacts necessary to put the plan into place requires the expenditure of time, money and effort on the part of the applicant. Because of the time and effort required to be expended by the applicant, in many instances IB applicants are forced to relinquish their pre-registration employment. Thus, at the point in time when many applicants file for registration as guaranteed IBs, they are often required to spend the eight to ten week fitness

review period in an idle and unemployed capacity.[1]

This period of forced idleness is unique to applicants for registration as guaranteed IBs and APs. No other categories of Commission registrants are required to establish a relationship with a registrant prior to submitting their registration applications. Thus, other categories of Commission registrants can generally continue in their pre-registration employment while their registration is pending.

NFA believes that to the extent that the Commission has determined to alleviate the hardship realized by AP applicants in having to await entrance into the futures industry in a period of idleness, equity requires that the same hardship be alleviated for the only analagous registration category - guaranteed IBs.[2]

B. **It should be an unlikely event that a temporarily licensed guaranteed IB is determined unfit for registration.**

As discussed earlier, it currently takes a minimum of eight to ten weeks to process a properly completed registration application even if NFA has received

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1 In this connection it should be noted that the minimum time necessary to conduct a full fitness review of any individual may be extended for reasons beyond the individual's control such as the FBI's inability to process a fingerprint card. The chances for this kind of further delay are increased in the case of an applicant for registration as a guaranteed IB which has multiple individual principals. Hence, the period of forced idleness for the individuals connected with such an applicant can be expected to often exceed the minimum period needed to complete a fitness inquiry.

2 It should also be noted that many guaranteed IBs are sole proprietors or "one-person" corporations. Hence, these IBs are actually no more than APs seeking a different legal registration status.

no derogatory information concerning the applicant. Much of this time is necessary to permit the FBI and the SEC to check their records to assist NFA in evaluating an applicant's fitness for registration. Commission registration experience, however, has led it to estimate that less than one percent of applicants are eventually found to be disqualified from registration because of past misconduct. (1982-1984 Transfer Binder) Comm. Fut. L. Rep. (CCH) ¶ 21, 885 at 27,766 (November 2, 1983). Of those who are found to be disqualified, the large majority indicate the basis for the disqualification on the registration application form. Since these persons are not eligible for temporary licenses, it is apparent that a temporary licensing system permits the people who would be eventually registered in any event to avoid processing delays without allowing any substantial number of disqualified persons to escape a prior fitness review.

Given the above estimate of disqualified applicants cited by the Commission, it should be an unlikely event that someone able to get a guarantee agreement from an FCM and pass a preliminary fitness examination by NFA's Registration Department will later be denied registration. If the unlikely does occur, and an applicant that receives a temporary license is later denied registration, the potential disruption to the customers and the employees of the IB should be minimal.

C. **Disruption to customers and employees of an IB that loses its license will be the same as those experienced when an FCM's branch office is closed.**

The guaranteed IB is in essence the functional equivalent of a branch office of an FCM. Experience has proven that disruptions to customers and employees of an FCM's branch office that is closed are minimal. The closing of a branch office is a common occurrence. NFA believes that the effect on customers of the very small number of IBs that may lose a temporary license will not be unusual or harsh and, as a result, the costs of extending temporary licenses to guaranteed IBs are not as great as envisioned by the Division.

An IB cannot accept customer funds. Further, all customers of the temporarily licensed IB will have

NFA

fully disclosed accounts at the registered FCM which is the guarantor of the IB. Because the FCM has an ongoing obligation and responsibility to customers of an IB that it guarantees, the FCM should continue to service the customer in the event that the temporary license of the IB is terminated just as it would continue to service customers of a closed branch office.

NFA hopes that with the information provided above, the Division will be able to recommend the approval of NFA's proposed amendments to Bylaw 305, Schedule A, Section 1(f). NFA stands ready to provide the Division with any other information that it believes would be helpful in considering NFA's proposed amendments.

Very truly yours,

Joseph H. Harrison
General Counsel & Secretary

JHH:cad

CDS-003/006

COMMODITY FUTURES TRADING COMMISSION
2033 K STREET, N.W., WASHINGTON, D.C. 20581

DIVISION OF
TRADING AND MARKETS

RECEIVED
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GENERAL COUNSEL'S OFFICE

May 14, 1986

Joseph H. Harrison, Esq.
General Counsel
National Futures Association
200 West Madison Street
Chicago, Illinois 60606

Re: Temporary Licenses for Guaranteed Introducing Brokers

Dear Mr. Harrison:

This is in response to your letter dated April 23, 1986 addressing the issues raised by the Division of Trading and Markets ("Division") with respect to the proposed amendments to National Futures Association ("NFA") Bylaw 305, Schedule A, Section 1(f), which, if approved by the Commodity Futures Trading Commission ("Commission"), would authorize NFA to issue a temporary license to qualified applicants for registration as an introducing broker that are guaranteed by a futures commission merchant ("FCM") in accordance with the provisions of Commission rule 1.10(j), 17 C.F.R. §1.10(j) (1985).

By letter dated February 10, 1986, the Division requested additional information to determine whether authorizing temporary licenses for qualified applicants for registration as a guaranteed introducing broker would be consistent with Commission policy in this regard as set forth in 49 Fed. Reg. 8208, 8209 (March 5, 1984). In this connection, the Division requested NFA to consider whether NFA would be prepared to adopt rules to require an FCM to perform preliminary fitness examinations of introducing broker applicants to be guaranteed by it and to require an FCM to supervise directly such guaranteed introducing brokers. In addition, the Division asked that NFA address why the benefits that may be achieved by extending temporary licensing to guaranteed introducing broker applicants outweigh the potential disruptions both to customers and employees of the introducing broker that may result from the termination of an ongoing business.

In its response, NFA states first that a rule requiring FCMs to conduct a preliminary fitness investigation is unnecessary. Under both Commission and NFA rules, an FCM is liable for the conduct of an introducing broker which it guarantees. Therefore, as a matter of sound business practice, NFA believes that FCMs will conduct such fitness examinations. With respect to direct supervision, NFA states that the rule to which the Division referred is already in place. A guaranteed introducing broker is an agent of

its guarantor FCM. Therefore, NFA compliance rule 2-9, which requires each NFA member to supervise diligently its agents, presently requires an FCM to supervise the conduct of guaranteed introducing brokers.

Finally, NFA asserts that the termination of a temporary license of an introducing broker would be no more disruptive to customers and employees than a decision by an FCM to close a branch office. In particular, the customer accounts solicited by the introducing broker would continue to be serviced by the FCM. This contrasts with the burden placed on introducing broker applicants that must invest substantial time, money and effort to establish a business plan prior to filing an application and then be subject to a minimum period of eight to ten weeks of forced idleness pending registration.

The Division has considered the information furnished by NFA and is satisfied that NFA compliance rule 2-9 will ensure the direct supervision of a guaranteed introducing broker that has received a temporary license by its guarantor FCM and, further, that the benefits to be derived from temporary licensing of guaranteed introducing brokers are not outweighed by the potential disruptions to customers and employees of a guaranteed introducing broker whose temporary license is terminated. 1/

The Division continues to believe, however, that the requirement that a guarantor FCM conduct a preliminary background investigation of an introducing broker applicant should be established by rule and that NFA should not rely solely on the business judgment of its member FCMs. A regulatory requirement will ensure that such background investigations are undertaken, since the failure to do so may result in an NFA disciplinary action. At the same time, however, based on NFA's own analysis, the requirement that such an investigation be conducted should not impose any additional burden on guarantor FCMs.

Thus, the Division asks NFA to consider amending its proposal to require that, as a condition of issuing a temporary license to an applicant for registration as a guaranteed introducing broker, NFA also receive from the applicant's guarantor FCM a certification to the effect that, with respect to the introducing broker applicant and any principals thereof, (1) the FCM has verified the information on the Forms 8-R filed with NFA which relate to the education and employment history of the applicant, if

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1/ In this connection, however, the Division wishes to make clear that, if any employee of a guaranteed introducing broker is acting in the capacity of an associated person pursuant to a temporary license, that temporary license would terminate upon the termination of the temporary license of its sponsor. See Commission rule 3.42(a)(2), 17 C.F.R. §3.42(a)(2) (1985). The employee would not be entitled to use the special registration procedures in Commission rules 3.12(d) and 3.16(d), 17 C.F.R. §§3.12(d) and 3.16(d) (1985).

appropriate, and its principals, and (2) to the best of the FCM's knowledge, information and belief, all of the publicly available information supplied by the applicant and its principals on the Form 7-R and Forms 8-R, as appropriate, is accurate and complete. Upon adoption of such an amendment, the Division is prepared to recommend that the Commission approve NFA Bylaw 305, Schedule A, Section 1(f). 2/

You should be advised that concurrent with its recommendation, the Division would also recommend that the Commission adopt a comparable amendment to its own regulations to authorize the issuance of a temporary license to qualified applicants for registration as an introducing broker. Although the NFA amendment provides that a guarantee agreement will become effective upon the issuance of a temporary license to an introducing broker applicant, this conflicts with the Commission's current registration rules, which provide that the guarantee agreement will become effective upon registration being granted. See Commission rule 1.10(j)(3), 17 C.F.R. §1.10(j)(3) (1985). Therefore, the Commission's rules will have to be amended to eliminate this conflict.

Moreover, because the Commodity Exchange Act ("Act") provides that registration is with the Commission, a fact which Congress emphasized in adopting section 8a(10) of the Act in 1982, 3/ the Division, with the concurrence of the Office of the General Counsel, believes it is essential that the minimum substantive requirements for registration with the Commission or, in this case, for the issuance of a temporary license to a qualified applicant, should be established by the Commission and set forth in the Commission's regulations. Maintenance of the Commission's own rules in this regard will facilitate Commission review of NFA registration rules in determining whether such rules are inconsistent with the Act and will also provide the most appropriate vehicle for amending the requirements for registration if the Commission determines to do so. 4/

2/ The Division wishes to make clear that it is prepared to make this recommendation with respect to guaranteed introducing broker applicants solely because of the relationship between such applicants and an existing registrant. The Division does not contemplate that any other category of registrant will have such a relationship with another registrant and, therefore, no other category of registrant will qualify for a temporary license.

3/ See, e.g., H. Rep. No. 565, 97th Cong., 2d Sess. 52. Section 8a(10) of the Act essentially provides that the Commission may authorize NFA to perform the Commission's registration functions under the Act in accordance with rules adopted by NFA and approved by the Commission.

4/ In this connection, the Division wishes to make clear that it is not its

(Footnote continued)

The statutory period within which the Commission must approve or initiate a proceeding to disapprove NFA's proposed amendments to Bylaw 305, Schedule A, Section 1(f) expires on June 9, 1986. In this connection, therefore, the Division requests that NFA grant an extension of time to a period not to exceed ninety days from receipt of NFA's response to this letter.

If you have any questions, please feel free to contact Linda Kurjan, Special Counsel, at 202/254-8955.

Very truly yours,

for Andrea M. Corcoran
Director

(Footnote continued)

position that NFA's registration rules are required to conform to the Commission's rules in every respect. To the contrary, NFA has the authority under section 8a(10) of the Act to supplement those rules with additional procedural or substantive requirements, e.g., proficiency testing, provided such requirements are not inconsistent with the Act or any rule, regulation or order of the Commission thereunder.

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

May 19, 1986

Andrea M. Corcoran, Esq.
Director
Division of Trading and Markets
Commodity Futures Trading Commission
2033 K Street, N.W.
Washington, D.C. 20581

Dear Ms. Corcoran:

Thank you for your letter of May 14, 1986 regarding temporary licenses for guaranteed Introducing Brokers. I appreciate your consideration of the proposed amendments to NFA Bylaw 305, Schedule A, Section I(f) ("the Amendment") and your suggestion that the Amendment be altered to require a guaranteeing FCM of an IB seeking a temporary license to complete a certification for principals of the IB applicant similar to that required of FCMs with respect to APs. NFA will place your suggestion before its FCM Advisory Committee and will act as quickly as possible on it.

This is to inform you that NFA consents to an extension of the statutory period within which the Commission must approve or initiate a proceeding to disapprove the Amendment until thirty days following NFA's response concerning the suggestion contained in your letter. However, be advised that it would be NFA's intention, if it chooses to alter its earlier submission to you, to resubmit the Amendment as a new submission and to withdraw the earlier submission.

Sincerely,

Joseph H. Harrison, Jr.
General Counsel

JHH:cm(D20/F34)

bcc: Mr. Howard A. Stotler

R.K. Wilmouth
J.W. Tippins
G.J. Byrne
D.A. Driscoll
N.B. Connolly
D.J. Roth
K.M. Dorff
C. Soldato

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

July 11, 1986

Ms. Jean A. Webb
Secretary
Commodity Futures Trading
Commission
2033 K Street, N.W.
Washington, D.C. 20581

Re: NFA Guideline for the Disclosure by FCMs and IBs of Costs Associated with Futures Transactions

Dear Ms. Webb:

By memorandum dated March 17, 1986, the Division of Trading and Markets recommended that the Commission approve the National Futures Association ("NFA") Guideline for the Disclosure by FCMs and IBs of Costs Associated with Futures Transactions ("Guideline"). The Guideline was in fact approved on April 3, 1986. However, because the Division's memorandum indicates that there may be some confusion concerning the requirement that FCM Members provide customers with purchase and sale ("P&S") or confirmation statements containing a reasonable breakdown of all fees and charges assessed in connection with all transactions, this letter is intended to clarify the position of NFA with respect to enforcement of that requirement.

Specifically, the Division's memorandum stated, in part, that:

> To ensure that the customer is aware of the costs incurred, every FCM Member must give to each customer (without exception) a reasonable breakdown, in writing, of all fees and charges assessed to the customer in connection with all transactions. Thus, this post-transaction disclosure requirement applies regardless of whether the fees and charges are determined on a per-trade, round-turn, or some other basis.[10] The Guideline does not specify, however, how fees and charges which are assessed other than on a per-trade or round-turn basis are to be displayed on the required customer statements. As a result, any affected FCM or IB Member will have to develop appropriate disclosures in light of the particular circumstances of its fee arrangement.

It is NFA's position that if the fees and charges associated with futures transactions are assessed on a per trade or round-turn

NFA

trade basis, then the fees and charges must be reflected on the P&S or confirmation statement at the same time that the trade or round-turn transaction is reflected. However, if the fees and charges are not assessed on a per trade or round-turn basis, but are charged "up front", then those "up front" costs must be reflected at the time that they are deducted from the customer's account or investment. Because the purpose of itemizing fees and charges on P&S or confirmation statements is to ensure that customers are aware of the actual costs incurred in connection with the futures trading in their account, there is no requirement that a fee that is charged "up front" be broken down and reflected on such statements as a reasonable estimate of the then current cost per transaction.

Very truly yours,

Barbara S. Farrar

Barbara S. Farrar
Attorney

/lac(Dll:F6)

COMMODITY FUTURES TRADING COMMISSION
2033 K STREET, N.W., WASHINGTON, D.C. 20581

DIVISION OF
TRADING AND MARKETS

COPY TO:
ATTORNEYS
NBC

July 23, 1986

Joseph H. Harrison, Esq.
General Counsel
National Futures Association
200 West Madison Street
Chicago, Illinois 60606

Re: Guideline for the Disclosure by FCMs and IBs of Costs Associated with Futures Transactions

Dear Mr. Harrison:

By letter dated July 11, 1986 and received by the Commission on July 14, 1986 (a copy of which is enclosed for your convenience), the National Futures Association submitted an interpretation of NFA's Guideline for the Disclosure by FCMs and IBs of Costs Associated with Futures Transactions. This is to inform you that the Division of Trading and Markets has reviewed the interpretive position set forth in that letter and has determined not to recommend that the Commission review that interpretation, as provided under Section 17(j) of the Commodity Exchange Act.

If you have any questions concerning this matter, please contact Kenneth M. Rosenzweig or Linda Kurjan.

Very truly yours,

Andrea M. Corcoran
Director

Enclosure

cc: Barbara Farrar, Esq.

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JUL 28 1986
RECEIVED
GENERAL COUNSEL'S OFFICE