

COMMODITY FUTURES
TRADING COMMISSION
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GENERAL COUNSEL'S OFFICE

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

Re: National Futures Association, Proposed Amendments
to: Bylaws 305 (Schedule A, Sections I(c) and (d))
and 705; Code of Arbitration Sections 3 and 10(g);
Compliance Rule 3-2; and Guideline for the Disclosure
by CPOs and CTAs of "Up Front" Fees and Organizational
and Offering Expenses.

Dear Ms. Webb:

Pursuant to Section 17(j) of the Commodity Exchange
Act, as amended ("The Act"), National Futures Association
("NFA") hereby submits to the Commodity Futures Trading Commis-
sion ("Commission") proposed amendments to NFA Bylaws 305
and 705, NFA Code of Arbitration Sections 3 and 10(g), NFA
Compliance Rule 3.2 and NFA's Guideline for the Disclosure
by CPOs and CTAs of "Up Front" Fees and Organizational and
Offering Expenses. These amendments were approved by the
Board of Directors on May 15, 1986.

I. THE AMENDMENTS

- A. Amendments to Bylaw 305, Schedule A, Sections I(c) and
(d) to revise NFA's procedures to deny, condition, suspend,
restrict or revoke registration (additions are underscored):

BYLAWS OF
NATIONAL FUTURES ASSOCIATION

* * *

CHAPTER 3
MEMBERSHIP AND ASSOCIATION WITH A MEMBER

Bylaw 305. Registration and Proficiency Requirements.

* * *

Schedule A

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I. REGISTRATION

(c) Grant, Denial, Suspension, and Revocation of Registration.

With respect to persons required to register under the Act pursuant to Section I(a) of this Schedule A, NFA may refuse to register, register conditionally, suspend or place restrictions on the registration or revoke the registration of any such person based upon the grounds for such action and the standards of fitness set forth in the Act applicable to registrations granted by the Commission. Registrations or temporary licenses may be granted by the President or Secretary or their designee. Final written orders denying registration, registering conditionally, suspending or restricting registration or revoking registration shall be made by the President, the Membership Committee or its designated Subcommittee in accordance with the procedures set forth in Section I(d) of this Schedule A; provided, however, that pending final determination, in cases submitted by the President to the Membership Committee or its designated Subcommittee, registration shall not be granted. Such designated Subcommittee shall consist of at least three members of the Membership Committee. Each member of the designated Subcommittee shall be appointed by a majority of the Membership Committee.

(d) Proceedings to Deny, Condition, Suspend, Restrict or Revoke Registration.

* * *

(3) Notice of Intent to Deny, Condition, Suspend, Restrict or Revoke Registration.

(A) Notice of Intent. On the basis of information obtained, NFA may at any time serve a Notice of Intent upon any person required to register under the Act pursuant to Section I(a) of this Schedule A that:

* * *

(iv) If an applicant for registration is acting in a capacity which requires registration pursuant to a temporary license such temporary license shall terminate five days after service on the applicant of the Notice of Intent.

* * *



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(9) Extensions. Any request for an extension of time for filing a written submission, reply or response must be made to the President, the Membership Committee or its designated Subcommittee as the case may be prior to the expiration of the time for filing. The President, the Membership Committee or its designated Subcommittee may grant such reasonable extensions of time as deemed appropriate.

[(9)] (10) Hearing Procedures.

* * *

[(10)] (11) Orders.

* * *

B. Amendment to Bylaw 705 adding reference to the IB category regarding composition of the Finance Committee (additions are underscored):

CHAPTER 7
COMMITTEES

* * *

Bylaw 705. Finance Committee.

There shall be a Finance Committee not having or exercising the authority of the Board, to advise the Executive Committee on matters of NFA financial policy including the establishment of major plans and priorities regarding the commitment and expenditure of NFA funds and the establishment of dues, assessments, fees and other charges upon Members and others. The Finance Committee shall consist of six (6) members as follows:

- (a) NFA's President,
- (b) NFA's Vice Chairman (who shall act as chairman of the Finance Committee), and
- (c) Four (4) other Directors as follows who shall not also be members of the Executive Committee and who shall be proposed by the Executive Committee and appointed by the Board at the first Board meeting in each fiscal year:
 - (i) One (1) Director representing contract markets,



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- (ii) One (1) Director representing FCMs or IBs,
- (iii) One (1) Director representing CPOs or CTAs, and
- (iv) One (1) Director who is a public representative.

C. Amendments to Code of Arbitration Section 3, to apply provisions concerning pre-dispute arbitration agreements to IB, CPO, CTA and Associate Members, and Section 10(g), to expressly allow summary suspension of Associates for failure to comply with an arbitration award (additions are underscored):

CODE OF ARBITRATION

* * *

Section 3. Pre-Dispute Arbitration Agreements.

Any pre-dispute arbitration agreement between a customer and an FCM, IB, CPO or CTA Member or Associate thereof that does not comply with Commission Rule 180.3 shall be unenforceable under this Code.

* * *

Section 10. Award.

* * *

(g) Failure to Comply.

The failure of a Member or employee thereof, or Associate, to comply with an award shall be grounds for disciplinary action under NFA Compliance Rules (see Compliance Rule 2-5). When any Member or employee or Associate thereof fails to comply with an award within 30 days from the date of transmittal of the award by NFA or such other period as specified in the award, and unless there is pending a request to modify the award under Section 10(c) or an application to vacate, modify or correct the award in a court of competent jurisdiction, that Member or Associate may, on seven days written notice, be summarily suspended by the President until such award has been satisfied.

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- D. Amendment to Compliance Rule 3-2 providing that closure orders will only be sent to the Appeals Committee upon referral by the President (deletions are [bracketed] and additions are underscored):

COMPLIANCE RULES

* * *

Part 3 - Compliance Procedures

* * *

RULE 3-2. INVESTIGATION.

(c) Review of Report.

Each investigation report shall be reviewed by the Regional Committee. If, upon review of the report, the Committee finds that additional investigation or evidence is necessary, it shall so instruct the Compliance Director. Within 30 days after receiving a completed report the Regional Committee shall either -

- (i) close the matter, if it finds (A) no reasonable basis that a violation has occurred, is occurring or is about to occur; or (B) that prosecution is otherwise unwarranted (in which case the Regional Committee may issue or cause to be issued a warning letter). The closure order shall be in writing and briefly state the reasons therefor, and a copy of the order shall be [sent to the Appeals Committee (see NFA Bylaw 702), which may direct the Regional Committee to issue a complaint as it deems appropriate] promptly furnished to the President. Such order shall become final 10 days after the President's receipt thereof unless, within such time, the President refers the matter to the Appeals Committee (see NFA Bylaw 702) for its review. In such case, the closure order shall become final 30 days after the date of referral by the President unless, within such time, the Appeals Committee directs the Regional Committee to issue a complaint; or
- (ii) serve a written and dated complaint, if it finds reason to believe that an NFA requirement is being, has been or is about to be violated and that the matter should be adjudicated.



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- E. Amendment to Guideline for the Disclosure by CPOs and CTAs of "Up Front" Fees and Organizational and Offering Expenses to specify a standardized amount of initial investment for use in the dilution table and to provide that periodic management fees are not "up front" fees within the meaning of the Guideline (additions are under-scored):

GUIDELINE FOR THE DISCLOSURE
BY CPOs AND CTAs OF
"UP FRONT" FEES AND
ORGANIZATIONAL AND OFFERING EXPENSES

Commodity Futures Trading Commission ("CFTC") Regulation 4.21(a)(7) states that the disclosure document of a CPO must contain a description of each expense which has been or is expected to be incurred by the pool. CFTC Regulation 4.31(a)(4) applies to CTAs and requires that the disclosure document of a CTA describe each fee which the CTA will charge the client. In addition, CFTC Regulations 4.21(h) and 4.31(g), respectively, require CPOs and CTAs to disclose all "material" information. These requirements have been incorporated into NFA Compliance Rule 2-13. Because "up front" fees and charges can have a significant impact on the net opening equity of pools and managed accounts, the above NFA rule requires not only disclosure of the existence and the amount of the up front charges but also disclosure of (1) how the up front charges affect the initial amount of capital available for trading and (2) the impact of the up front charges on net performance as reflected on a CPO's or CTA's performance table.

A. Disclosure of Prospective Up Front Fees and Charges

CPOs and CTAs that intend to charge up front fees and expenses to participants in a pool or clients in a managed account must disclose that fact in the disclosure document. To ensure that investors are fully aware of not only the amount of such charge but also its impact on the net proceeds that will be available at the outset for futures trading, such disclosure should be highlighted in a tabular format on the cover page of the disclosure document ("dilution table"). The suggested format for the table would detail a standardized amount of initial investment, all up front fees and charges, including all organizational and offering expenses, and the net proceeds that would be available for trading after deducting the up front expenses. If a CPO or CTA does not use standardized amounts, minimums or units for initial investments,



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the required table should be presented showing dilution of an investment of \$1,000. Moreover, if the results in the dilution table, without further explanation, could be materially misleading as to the impact of the up front fees and charges on the amount of initial capital available for trading (for example, because the fees as a percentage of the initial investment vary depending on the amount of the investment), then explanatory footnotes should be used.

The extent to which a CPO or CTA breaks down the up front expenses into categories, including, but not limited to, fees, organizational and offering expenses, legal fees and accounting fees, is solely within the discretion of the CPO or CTA as long as the net proceeds for trading and the portion that is deducted from the initial investment are clearly delineated as such. All fees that are charged up front must be disclosed except that a CPO or CTA that charges periodic management fees on the first day of each period, including the initial period, need not describe such fees for the first period in the dilution table.

B. Treatment of Up Front Fees in the Performance Table

CPOs and CTAs that charge up front fees and expenses to participants or clients must reflect contributions to a pool or beginning equity balances of a managed account before consideration of such expenses in preparing the performance table required by NFA Rules. However, a CTA acting as an independent advisor to a commodity pool is not required to incorporate into the beginning equity balance of its performance table the up front fees or organizational or offering expenses charged by the CPO.

All up front fees and organizational expenses must be reflected as a reduction of net performance in the period in which the contribution was made to the pool or clients managed account unless such fees and expenses can be amortized pursuant to Generally Accepted Accounting Principles.* If organization or syndication expenses can be, and are, amortized, then net performance shall be reduced each month by the monthly amortizable amount. The monthly amortizable amount shall be calculated by dividing the total amount of amortizable expenses by the total number of months over which such expenses shall be amortized.

*Section 709 of the Internal Revenue Code, 26 U.S.C. §709, governs whether or not organization and syndication expenses incurred to organize and to promote the sale of interests in a partnership can be amortized.



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II. Explanation of the Amendments

- A. Explanation of amendments to Bylaw 305, Schedule A, Sections I(c) and (d) to revise NFA's procedures to deny, condition, suspend, restrict or revoke registration.

On September 30, 1985 the CFTC delegated to NFA the authority to conduct proceedings to deny, condition, suspend, restrict or revoke registration for FCMs, IBs, CPOs, CTAs and their APs. In order to take on this responsibility, NFA adopted rules set forth in Bylaw 305, Schedule A, Sections I(c) and (d) ("Denial Rules"). Based on its experience in working with the Denial Rules NFA has adopted proposed amendments which will accomplish three things. First, Section I(c) will now specify the composition of the Subcommittee which can be appointed by the Membership Committee to hear cases. The Subcommittee will consist of at least three members of the Membership Committee, and Subcommittee members will be appointed by majority vote of the Membership Committee. Second, a new paragraph (3)(A)(iv) of Section I(d) will expressly state that when denial proceedings are initiated against an applicant currently acting in a registered capacity pursuant to a temporary license, such temporary license shall automatically terminate. This is the same result which obtains under Commission Regulation 3.42(a)(1) when the Commission initiates denial proceedings. Third, a new paragraph (9) of Section I(d) will expressly allow the President, the Membership Committee or its designated Subcommittee to grant reasonable extensions of time for the filing of written submissions. Former paragraphs (9) and (10) have accordingly been renumbered.

- B. Explanation of amendment to Bylaw 705 adding reference to the IB category regarding composition of the Finance Committee.

When an IB Director was added to NFA's Board of Directors, the FCM Director category became the FCM and IB Director category. NFA has now adopted a technical amendment to Bylaw 705 to conform the Bylaw to this revision. This amendment makes the IB Director eligible to serve on the Finance Committee in the same manner that the IB Director is now eligible to serve on the Executive Committee.

- C. Explanation of amendments to Code of Arbitration Section 3, to apply provisions concerning pre-dispute arbitration agreements to IB, CPO, CTA and Associate Members, and Section 10(g) to expressly allow summary suspension of



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Associates for failure to comply with an arbitration award.

Section 3 of the Code provides that a pre-dispute arbitration agreement between a customer and an FCM that does not comply with Commission Regulation 180.3 is unenforceable under the Code. The application of Section 3 is currently limited to agreements between customers and FCMs because, at the time that Section 3 was adopted, CFTC Regulation 180.3 applied only to FCMs. Since that time, however, Commission Regulation 180.3 has been amended to apply to all categories of registrants and their associated persons. Therefore, to conform Section 3 to Commission Regulation 180.3, NFA proposes to amend Section 3 to apply not only to FCMs but also to IBs, CPOs, CTAs and their Associates.

Section 10(g) of the Code provides that when a Member or employee thereof or Associate fails to comply with an arbitration award, absent a pending request to modify the award or an application before a court to modify or correct the award, that Member may, on seven days written notice, be summarily suspended by the President until the award has been satisfied. NFA has interpreted Section 10(g) to allow for the summary suspension of both Members and Associates. In order to clarify the applicability of the section and to make the language consistent with NFA's interpretation, the proposed amendment to Section 10(g) would expressly state that Associates may also be summarily suspended for failure to comply with an arbitration award.

- D. Explanation of amendment to Compliance Rule 3-2 providing that closure orders will only be sent to the Appeals Committee upon referral by the President.

NFA Compliance Rule 3-2(c) currently provides that copies of all closure orders issued by NFA's Regional Business Conduct Committees ("BCCs") "shall be sent to the Appeals Committee . . . which may direct the Regional Committee to issue a complaint as it deems appropriate." This review of closure orders provides assurances that similar cases are given similar treatment by NFA's three BCCs.

Because of the high volume of closure orders requiring review and because all closure orders reviewed by the Appeals Committee thus far have been affirmed, the Appeals Committee recommended and NFA's Board of Directors agreed that NFA Compliance Rule 3-2(c) be amended so that closure orders are



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subject to Appeals Committee review only upon referral by NFA's President. NFA believes that initial screening by the President will ensure uniformity in the BCCs' decisions and will relieve the Appeals Committee of the obligation to perform a perfunctory review of a large number of purely routine matters. The proposed amendment provides that closure orders will be sent to the President of NFA, who has the discretion to refer the matter to the Appeals Committee for further review. If the President makes no referral within 10 days after receipt of the closure order, the order will become final. If the closure order is referred to the Appeals Committee, it will become final 30 days after the date of referral unless, within that time, the Appeals Committee directs the BCC to issue a complaint.

- E. Explanation of amendment to Guideline for the Disclosure by CPOs and CTAs of "Up Front" Fees and Organizational and Offering Expenses to specify a standardized amount of initial investment for use in the dilution table and to provide that periodic management fees are not "up front" fees within the meaning of the Guideline.

On August 15, 1985, the Board of Directors approved the Guideline for the Disclosure by CPOs and CTAs of Up Front Fees and Organizational and Offering Expenses ("Guideline"). The Guideline, which is intended to clarify the disclosure obligations of CPOs and CTAs pursuant to NFA Compliance Rule 2-13, contains two sections. Section A requires that the cover page of the Disclosure Document contain a dilution table setting forth a standardized amount of initial investment, all up front fees and charges and the net proceeds that will be available for trading after deducting the up front fees and charges. Section B requires that the performance tables of CPOs and CTAs, except CTAs acting as independent advisors to commodity pools, reflect contributions to a pool or beginning equity balances of a managed account before consideration of up front fees and expenses.

The Guideline was approved by the Commission on January 28, 1986. In its approval letter, the Commission requested clarification concerning use of a "standardized" amount of initial investment by Members that do not require that their customers invest standardized amounts, minimums or units. In addition, certain industry participants have questioned whether a commodity trading advisor or commodity pool operator who charges periodic management fees on the first day of each period, including the initial period, must



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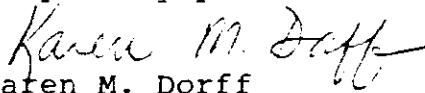
describe such fees in the dilution table on the cover page of the Disclosure Document.

NFA's CPO/CTA Advisory Committee considered these issues and recommended amendments which have now been adopted by the Board. The amendment to the first paragraph of Section A specifies that CPOs and CTAs that do not use standardized amounts for initial investments must use \$1,000 as their standardized amount of initial investment in the dilution table. It also requires that further explanation (in the form of footnotes) must be provided if the results in the dilution table could otherwise be misleading. The amendment to the second paragraph of Section A clarifies that a periodic management fee need not be included in the dilution table as an "up front" fee even though such fee is charged at the beginning of each period, including the first period.

NFA respectfully requests that the amendments to Bylaw 305, Schedule A, Section I(c) and (d), Bylaw 705, Code of Arbitration Section 3 and 10(g) and Compliance Rule 3-2 be declared effective upon approval of the Commission.

With respect to the proposed amendments to the Guideline for the Disclosure of "Up Front" Fees, upon approval NFA intends to put the Guideline into effect on July 1, 1986. Thus, NFA intends to require that all disclosure documents dated on or after July 1, 1986, contain the dilution table described in Section A of the Guideline, and that all contributions to a commodity pool or managed account made on or after July 1, 1986, be treated in the performance table according to Section B of the Guideline. NFA therefore requests that the Commission expedite its review of the amendments to the Guideline, one of which was adopted in response to a specific Commission concern.

Very truly yours,


Karen M. Dorff
Assistant General Counsel

cc: Chairman Susan M. Phillips
Commissioner Kalo A. Hineman
Commissioner Fowler C. West
Commissioner William E. Seale
Commissioner Robert R. Davis
Andrea M. Corcoran, Esq.
Kenneth M. Raisler, Esq.
Dennis Klejna, Esq.
Kevin M. Foley, Esq.
Kenneth M. Rosenzweig, Esq.
Linda Kurjan, Esq.

UNITED STATES OF AMERICA
COMMODITY FUTURES TRADING COMMISSION

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



June 13, 1986

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

Re: Amendments to National Futures Association Bylaws 305
(Schedule A Sections I(c), I(d) (3), (9), (10) and (11))
and 705; Code of Arbitration Sections 3 and 10;
Compliance Rule 3-2(c); and Guideline under Compliance
Rule 2-13 for the Disclosure by CPOs and CTAs of "Up
Front" Fees and Organizational and Offering Expenses.

Dear Mr. Harrison:

This is to inform the National Futures Association that on June 13, 1986, the Commission approved the captioned NFA rule amendments as submitted by letter dated May 22, 1986, from Karen M. Dorff, NFA Assistant General Counsel. The amendments relate to the adverse registration action process; the composition of NFA's Finance Committee; the provision on pre-dispute arbitration agreements; the suspension for failure to comply with an arbitration award; the procedure for compliance investigation closure orders; and CPO/CTA fee disclosure.

Very truly yours,

Jean A. Webb
Jean A. Webb
Secretary of the Commission

✓cc: Karen M. Dorff