

December 6, 1982

Ms. Jane K. Stuckey
Office of the Secretariat
Commodity Futures Trading Commission
2033 K Street, N.W.
Washington, D.C. 20581

Dear Ms. Stuckey:

Pursuant to Section 17(j) of the Commodity Exchange Act and Part 33 of the Rules of the Commodity Futures Trading Commission ("CFTC"), National Futures Association ("NFA") hereby files with the CFTC and requests CFTC approval of the following amendments to NFA Compliance Rules. NFA also hereby submits for review by the CFTC a copy of the written audit objectives and procedures (attached hereto as Exhibit A) which will be used by NFA in the course of conducting the audits and inspections required of a self-regulatory organization under Part 33 of the CFTC Rules. These submissions are made pursuant to a resolution of the Board of Directors of NFA, adopted October 14, 1982, by which NFA determined to provide for the regulation of the commodity option related activities of its Member FCMs.

The following amendments to NFA Compliance Rules, in conjunction with existing NFA Compliance Rules and the attached audit objectives and procedures, are designed to provide for the regulation of the commodity option related activities of Member FCMs in a manner which is at least equivalent to that required of contract markets under Part 33 of the CFTC's Rules. NFA has assembled a large and capable staff which consists of individuals with extensive cumulative experience in various capacities with FCMs, contract markets, accounting and law firms and the CFTC. Upon the effective date of CFTC approval of the following additional Compliance Rules, NFA will be prepared to perform routine option sales practice audits in addition to NFA's other compliance auditing functions. At least once every two years NFA will conduct a full scope option sales practice and compliance audit of each FCM for which NFA is the designated self-regulatory organization in conjunction with an NFA full scope financial compliance audit. The full audits will test for compliance with all NFA exchange traded option rules. NFA will supplement these full audits with interim limited scope sales practice examinations. NFA will



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also conduct periodic audits of branch offices and agents of Member FCMs.* NFA's regulation of the activities of its Member FCMs related to options on futures is designed to be equally effective in regulating those activities which may relate to options on physicals.

NFA will be the designated self-regulatory organization for FCMs which are not members of any contract market. By agreement with the various contract markets, which will be submitted for CFTC approval pursuant to CFTC Rule 1.52, NFA may delegate its duties under Part 33, with respect to a Member FCM which is a member of one or more contract markets, to a contract market of which the FCM is a member.

The following amendments to NFA Compliance Rules have not been formally adopted by the Board of Directors of NFA. We will advise the CFTC by supplemental letter of the date of adoption of the amendments by the Board of Directors.

The Amendments

The proposed amendments would add the following rules to Part 2 of the NFA Compliance Rules designated as indicated. An explanation of each proposed rule follows its text.

Rule 2-15. WRITTEN OPTION PROCEDURES

Each Member FCM which engages in the offer or sale of commodity options traded on or subject to the rules of a contract market must adopt and enforce written procedures (see Rule 2-21) which will enable such Member FCM to:

*If the amendments to the Commodity Exchange Act contained in H.R. 5447 and the Senate Amendment to H.R. 5447 which would establish the "Introducing Broker" registration requirement are enacted, NFA anticipates adopting procedures to include Member introducing brokers in NFA's program of audits and examinations once the CFTC has determined the status of introducing brokers within the options pilot program.



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- (a) Supervise adequately each option customer's account, including but not limited to, the solicitation of any such account and the handling of complaints relating to any such account (for purposes of this subsection (a) the term "option customer" does not include another FCM);
- (b) Allocate notices of exercise received by such FCM in a fair and non-preferential manner, and promptly notify the appropriate grantor of such allocation; and
- (c) Monitor adequately the solicitation and sale of deep-out-of-the-money options. For purposes of this subsection (c) such FCM shall define the term "deep-out-of-the-money option" as that term is defined by the contract market on which the option is traded.

Explanation: This provision satisfies the requirements of CFTC Rule 33.4(b)(5) and also requires procedures similar to and consistent with those required by contract markets concerning allocation of exercise notices and sales of deep-out-of-the-money options.

Rule 2-16. OPTION SALES COMMUNICATIONS

No Member or Associate shall employ fraudulent or high pressure sales communications relating to the offer or sale of commodity options traded on or subject to the rules of a contract market.

Explanation: This provision satisfies the requirements of CFTC Rule 33.4(b)(10) and is drafted to extend its prohibitions to all NFA Members.

Rule 2-17. PAYMENT OF OPTION PREMIUMS

Any Member FCM that accepts an order from a customer to purchase a commodity option traded on or subject to the rules of a contract market shall receive from such customer the full amount of each option premium within the



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time prescribed for the receipt of such premium by the rules of the contract market on which the option is traded.

Explanation: This provision satisfies the requirement of CFTC Rule 33.4(a)(2) and is consistent with the discussion of that Rule in the Federal Register release announcing adoption of the option pilot program regulations. The preamble to that release indicates that the CFTC does not interpret CFTC Rule 33.4(a)(2) to require that option premiums be paid prior to the purchase of the option, but only that prompt payment be contemplated at the time of such purchase. Proposed Rule 2-17 is drafted to incorporate the premium payment rules of the various contract markets in order to avoid presenting Member FCMs with conflicting requirements concerning collection of premiums.

Rule 2-18. OPTION CUSTOMER COMPLAINTS

With respect to all written option customer complaints and any oral option customer complaints which result in, or which would result in, an adjustment to the option customer's account of more than \$1,000, each Member FCM which engages in the offer or sale of commodity options traded on or subject to the rules of a contract market shall:

- (a) Retain all such written complaints and make and retain written records of all such oral complaints;
- (b) Make and retain a record of the date the complaint was received, the Associate who serviced the account, a general description of the matter complained of, and what, if any, action was taken in regard to the complaint; and
- (c) Immediately send a copy of such complaint to NFA and, upon final disposition thereof, immediately send a copy of the record of such disposition to NFA.

Explanation: This provision satisfies the requirements of CFTC Rule 33.4(b)(4) regarding the handling of customer complaints and notification to the self-regulatory organization.



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Rule 2-19. OPTION DISCLOSURE AND OTHER REQUIREMENTS

Each Member FCM which engages in the offer or sale of commodity options traded on or subject to the rules of a contract market shall:

- (a) Give immediate written notification to NFA of any disciplinary action taken against the FCM or any of its Associates by the Commission or by any other self-regulatory organization;
- (b) Comply with and enforce the disclosure requirements set forth in Commission Regulation 33.7; and
- (c) Promptly submit to NFA all promotional material, as defined in Commission Regulation 33.1, pertaining to such option trading.

Explanation: This provision satisfies the requirements of CFTC Rules 33.4(b)(6), (7) and (8). The preamble to the Federal Register release announcing adoption of the options pilot program rules indicates that the CFTC considers that, as a part of an FCM's duty of disclosure, it must make every reasonable effort to ensure that all option customers and prospective option customers are informed as to the risks involved in options trading and 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. The preamble further states that the CFTC will leave the extent of an FCM's inquiry into the circumstances of each option customer to the prudent judgment of the FCM. The specific requirement of compliance with CFTC Rule 33.7 (including, of course, subsection 33.7(f)) contained in Proposed Rule 2-19(b), in conjunction with the comprehensive requirements of existing Compliance Rule 2-4, will permit the Business Conduct Committees of NFA to enforce the general option disclosure duties of each Member FCM, giving weight, as the CFTC notes, to its prudent judgment. In addition, subsection (c) will enable NFA to review promotional materials and determine whether such materials are fraudulent.



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Rule 2-20. DISCRETIONARY OPTION CUSTOMER ACCOUNTS

With respect to any option customer account for which discretion is given for option trading (other than an account (i) of a commodity pool, the operator of which is registered with the Commission as a CPO; (ii) where the person who has discretionary authority is the spouse, parent or child of the option customer; or (iii) which is an omnibus account of another FCM) each Member FCM shall:

- (a) Provide the option customer with an explanation of the nature and risks of the strategy or strategies to be used in connection with the option customer's account;
- (b) Ensure that an officer, general partner, sole proprietor, or branch office manager of the FCM (other than any individual authorized to exercise discretion in trading the account) approves, in writing, the discretionary authority prior to any trading for the account;
- (c) Identify each order as discretionary at the time of entry and ensure that an officer, general partner, sole proprietor, or branch office manager of the FCM (other than any individual authorized to exercise discretion in trading the account) approves, initials and dates all orders for a discretionary account; and
- (d) Review frequently all discretionary accounts.

Explanation: This provision satisfies the requirements of CFTC Rule 33.4(b)(9).

Rule 2-21. SUBMISSIONS TO NFA RELATING TO OPTIONS

Any Member FCM with respect to which NFA is the designated self-regulatory organization for purposes of Part 33 of the Commission Regulations shall submit to NFA the following material at



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least 10 days prior to the date such FCM begins the offer or sale of options traded on or subject to the rules of a contract market:

- (a) Option customer account agreement forms;
- (b) Option disclosure statements required by Rule 2-19(b);
- (c) Promotional material, as defined in Commission Regulation 33.1, (if such promotional material has been prepared); and
- (d) Written procedures required under Rule 2-15.

Documents required to be submitted to NFA under Rules 2-18, 2-19 and 2-21 will be considered submitted as of the date received by NFA at its Chicago office.

Explanation: This rule will ensure that NFA is notified prior to an FCM's entry into the option sales business which will enable NFA compliance staff to effectively identify and address any potential problem areas that a non-exchange member FCM might encounter prior to its entry into the business.

Petition for Confidential Treatment

Under CFTC Rule 145.9 (17 C.F.R. 145.9 (1982)) NFA hereby requests confidential treatment of the material in Exhibit A attached hereto, which consists of proposed NFA audit programs. These programs have been developed by NFA staff to assist it in monitoring compliance with NFA and CFTC rules pertaining to sales practices and the handling of options customer accounts. The disclosure of these audit programs to the public or to persons under the regulatory authority of NFA might reveal investigatory procedures utilized by NFA and reduce its effectiveness as a self-regulatory organization. Furthermore, disclosure of the audit programs might reduce the effectiveness of the CFTC's rule enforcement efforts, insofar as the CFTC relies on NFA to monitor its Members for compliance with CFTC rules.



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Conclusion

NFA respectfully requests that the amendments to NFA Compliance Rules set forth in this submission be declared effective upon approval by the CFTC. NFA further requests that such approval acknowledge the determination of NFA to provide for the regulation of the commodity option related activity of its Member FCMs in a manner equivalent to that required of contract markets under Part 33 of the CFTC's Rules and specifically authorize NFA, for purposes of the requirements of CFTC Rule 33.3, to undertake such regulation.

Very truly yours,

NATIONAL FUTURES ASSOCIATION

By 
Joseph H. Harrison, Jr.
General Counsel and Secretary

JHH:cv

cc: Chairman Philip McBride Johnson
Commissioner James M. Stone
Commissioner Fowler C. West
Commissioner Kalo A. Hineman
Commissioner Susan M. Phillips
Theodore W. Urban
Andrea M. Corcoran

NATIONAL FUTURES ASSOCIATION
OPTION ORDERS

Firm _____ Audit Date _____

AUDIT OBJECTIVES

Determine that the firm's procedures for handling option orders are adequate to insure that transactions are properly recorded and reported to the customer.

AUDIT PROCEDURES

1. Perform a test of the firm's procedures in handling option transactions and the adequacy of its clearing procedures as follows:
 - A. Select a sample of days throughout each quarter of the year prior to the audit date.
 - B. Use the following origination points and trace information therein to all other points.
 - 1) Customer orders check the following:
 - a. date
 - b. account designation
 - c. option/future
 - d. strike price
 - e. premium
 - f. three time stamps; upon receipt, transmission to clearing broker, and execution.
 - g. quantity
 - 2) Clearing Broker Statement check the following:
 - a. date
 - b. account designation
 - c. option/future
 - d. quantity
 - e. strike price
 - f. premium
 - 3) Firm originated document (confirmation, day trade listing, or month end statement) check the following:
 - a. date
 - b. account designation
 - c. option/future
 - d. strike price
 - e. premium
 - f. quantity
2. Perform a test of accuracy of the firm's data processing system as follows:
 - A. Select a sample of trades from the audit date based on the total number of transactions on that day.

- B. From the document used in Step 1(R), trace applicable information to all computer runs generated by the firm. Determine whether trade results in an open position or a liquidation.
 - C. If trade results in an open position:
 - 1) Obtain copy of margin equity run for that account and include in documentation.
 - a. Test clerical accuracy
 - b. Trace the settlement price to an external source.
 - c. Trace amount of ledger balance and open trade equity to month-end statement.
 - d. Trace position to those open on the month-end statement.
 - e. If account is undermargined include in margin testing.
 - 2) Trace to additional computer runs including point balance, position reports, etc.
 - D. If trade results in a liquidation:
 - 1) Obtain copy of P & S Statement.
 - a. Test clerical accuracy
 - b. Trace P & S gains or losses to entry on the month-end statement.
 - c. Determine that the firm is charging commissions in accordance with its procedures
 - d. Determine that the NFA fee is being assessed properly.
 - e. Trace to additional computer runs, if applicable.
 - 2) Trace to additional computer runs including point balance, position reports, etc.
 - E. If an adjustment to an account is noted above, review the customer account documentation for customer complaints.
3. Determine that each customer is informed, as can be reasonably approximated, of all costs and fees, strike price, and premium in connection with the option transaction as well as all costs that can be incurred upon exercise of the option.

NATIONAL FUTURE ASSOCIATION
OPTION MARGINS

Member Firm _____ Audit Date _____

AUDIT OBJECTIVES

1. To determine that the firm's margin procedures are adequate to insure contract performance as well as to serve as a continuous check on the financial capabilities of its customers.
2. Margin rates charged are in accordance with the applicable Rules and Regulations.

AUDIT PROCEDURES

1. Obtain a list of firm's margin rates and compare to exchange minimums.
2. Select a sample of option accounts subject to margin call and determine the number of days an account has been undermargined, the amount and date of all outstanding calls, and the subsequent disposition of the undermargined status of the account using the following procedures:
 - A. Margin the account using firm rates and NFA procedures until call is met in accordance with NFA procedures or a maximum of 10 business days past selected date. After margining for 10 days then look at the monthly activity statement for any liquidations, activity, or cash deposits.
 - B. On the first day of margining, all open positions with trade dates should be recorded.
 - C. All activity in the account must be shown on the margin worksheets including: Change in positions and cash, favorable market move, changes in NFA computed and firm actual margin calls, and calculation of NFA and firm margin calls.
 - D. Analyze difference between NFA's computed call and the firm's call.
 - E. If the firm rounds the call amount, follow the firm's procedures.
 - F. When counting the number of days that a margin call has been outstanding use the following method:

Day A: The day the account becomes undermargined.
Day B: The day the call is sent to the customer.
Day 1: The first day the call has been outstanding.
 - G. Insure proper hedge letters are on file for hedge customers, and that hedge margin rates are only applied to those commodities specified.
3. Select a sample of long positions and test to insure that the premium is deposited within the time period set forth by the rules of the appropriate contract market .
4. Cross reference any undermargined accounts, as reduced for acceptable margin calls, which would result in a charge to capital. Determine that this account is included in the total charge to capital and is properly reflected on NFA Supplementary Schedule 5.

NATIONAL FUTURES ASSOCIATION
DISCRETIONARY ACCOUNTS

Member Firm _____ Audit Date _____

AUDIT OBJECTIVES

1. To determine whether policies and procedures are in compliance with NFA rules.
2. To determine whether the firm employs adequate supervision of discretionary option accounts.

AUDIT PROCEDURES

1. Prepare a procedures analysis. Insure that the firm:
 - A. Provides its option customers with an explanation of the nature and risks of the strategy or strategies to be used in trading the account.
 - B. Reviews the discretionary accounts frequently.
2. Select a sample of _____ discretionary accounts trading options which do not fall into the following categories:
 - A. A commodity pool account, where the pool operator is registered with the CFIC.
 - B. An omnibus account of another FCM.
 - C. An account where the individual holding Power of Attorney (POA) is a member of the customer's family. Examine documentation on file to insure that the firm is adhering to procedures described.
3. For accounts selected, insure that written approval by the appropriate level of authority was given prior to trading.
4. Select a sample of office orders and review for the following:
 - A. The order ticket is specifically identified as a discretionary order.
 - B. The order has been approved, initialed and dated by the appropriate level of authority.
5. Determine whether any options discretionary accounts have been terminated.

NATIONAL FUTURES ASSOCIATION
IN-THE-MONEY OPTIONS

Member Firm _____ Audit Date _____

AUDIT OBJECTIVES

To determine whether the procedures for notifying customers of in-the-money options are adequate and adhered to.

AUDIT PROCEDURES

1. Prepare a description of the firm's procedures to notify customers of the in-the-money options.
2. Review firm's records for _____ months to determine if any in-the-money options have expired.
 - A. Review firm's notification to customer.
 - B. Determine if a pattern exists.
3. Select _____ in-the-money options for _____ delivery months and review the last 20 days of trading for the following:
 - A. Did the firm notify the customer of the option in-the-money position?
 - a. By what means?
 - b. When in the option life?
 - c. How often?
 - B. Review firm's procedures for consistency between customers?
 - C. Determine if any of the options were allowed to expire by the customer.

NATIONAL FUTURES ASSOCIATION
OPTIONS SALES PRACTICES

Firm _____ Audit Date _____

AUDIT OBJECTIVES

1. To insure that fraudulent, misleading or unreasonably high-pressure sales communications are not being utilized by the firm to induce sales.
2. To insure that proper supervision is being conducted by the firm over its sales personnel and over each option - customer's account.
3. To monitor the sales activities of the firm with respect to deep-out-of-the money options.

AUDIT PROCEDURES

1. Determine who within the firm is responsible for:
 - a) Supervision over the option customer's accounts
 - b) Supervision over the salespersons
 - c) Training of the salespersons
 - d) Supervision over the preparation and/or dissemination of sales promotional material
 - e) Supervision over branch office or agent activities
2. Determine and review with appropriate personnel identified in #1 above, the firm's policies and procedures concerning sales practices and the supervision of same, as well as the supervision or oversight procedures for option customers' accounts.
3. Obtain and review all written procedures and policies the firm utilizes to supervise option customer accounts.
4. Ascertain and document other procedures (non-written) the firm utilizes to supervise option customer accounts.
5. Determine if the procedures and policies of the firm appear adequate in terms of their scope and frequency of review.
6. Obtain and review all written procedures and policies the firm utilizes to train and supervise salespersons.
7. Ascertain and document other procedures (non-written) the firm utilizes to train and supervise salespersons.
8. Determine if the procedures and policies of the firm appear adequate in terms of their scope and frequency of review.
9. Obtain and review copies of all promotional materials utilized by the subject firm. Insure that these materials were filed with NFA.
10. Determine if written sales scripts are utilized and obtain copies of all such sales aids utilized by the firm.

11. Review options customer complaint files for potential fraudulent or high-pressure sales tactics.
12. To the extent feasible, monitor sales calls to determine if high pressure telephone solicitations are being made.
13. Determine if firm has taken any disciplinary actions against violators of the firm's procedures regarding sales practices.
14. Review the firm's supervisory procedures regarding branch offices/agents and determine whether such procedures appear adequate in scope and frequency of review.
15. Review the firm's procedures and policies regarding the offer and sale of deep-out-of-the-money options.
 - A) Review day trade listings, open position listings, or other sources available to determine if:
 - 1) an unreasonable amount of deep-out-of-the-money options have been sold;
 - 2) particular salespersons have large(r) amounts of deep-out-of-the-money options sales.
 - B) Ascertain that proper risk disclosure and sales solicitation takes place in sales of deep-out-of-the-money options.

NATIONAL FUTURES ASSOCIATION
EXERCISE AND ASSIGNMENT

Member Firm _____ Audit Date _____

AUDIT OBJECTIVES

1. To determine whether the firm's written procedures are in compliance with NFA rules.
2. To insure that the firm's written procedures are being adhered to.

AUDIT PROCEDURES

1. Prepare a procedures analysis
2. Review firm's written procedures for compliance with NFA rules.
3. Select _____ exercise notices that have been assigned for _____ options and review for the following:
 - A. Are notices assigned in accordance with NFA rules.
 - B. Apply firm's procedure to test their system.
 - C. Determine that customers are notified of exercise assignments.
 - 1) Review firm's records for evidence of notification.
 - 2) Determine if customers are notified prior to next day's trading.
 - 3) Confirm customer notification if deemed necessary.
 - 4) Determine firm's course of action if customer cannot be reached.

NATIONAL FUTURES ASSOCIATION
OPTIONS BRANCH OFFICE AUDIT

Firm Name _____ Audit Date _____

AUDIT PROCEDURES

1. On a sample basis visit _____ branch offices of an NFA member FCM. Include in the selection process a review of the option customer complaints, geographic location, and discussion with the Audit Supervisor or Manager.
2. Prepare procedures analysis in the following areas:
 - A. Order handling
 - B. Customer accounts and complaints
 - C. Discretionary accounts
 - D. Sales practices
3. In each of the areas cited above, apply the necessary audit steps as indicated in the given audit programs.

NATIONAL FUTURES ASSOCIATION
CUSTOMER ACCOUNTS/CUSTOMER COMPLAINTS

Member Firm _____ Audit Date _____

AUDIT OBJECTIVE

1. To determine that adequate documentation exists for customer accounts .
2. To insure that the firm has a system of handling option customer complaints, including definable policies and procedures to resolve such complaints.
3. To determine whether the firm is implementing such a system of handling options customer complaints so as to comply with NFA rules.

AUDIT PROCEDURES

CUSTOMER ACCOUNTS:

1. Prepare an option customer account procedure analysis.
2. Determine whether firm is applying procedures discussed in the analysis by examining _____ customer files.
3. Verify that the option customer received the risk disclosure statement and that the acknowledgement was on file prior to trading.

CUSTOMER COMPLAINTS:

1. Determine who within the firm is responsible for investigating options customer complaints.
2. Determine who will be responsible for responding to or resolving options customer complaints.
3. Review with the appropriate personnel identified in 1 & 2 above the firm's policies and procedures concerning the handling of options customer complaints.
4. Reconcile any complaints or compliance inquiries received by NFA to those on file within the firm. Determine whether the firm has had any contact with the complainant and how each matter was resolved.
5. Determine if the firm is retaining all written options customer complaints and if the firm is making and retaining records of all oral options customer complaints.
6. Determine if the firm is making and retaining a record of:
 - a. The date each options customer complaint was received
 - b. The associated person who serviced the account
 - c. A general description of the nature of the complaint
 - d. What, if any, action was taken by the subject firm in regard to the complaint.
7. Obtain a listing of unresolved options customer complaints that would result in an adjustment to the customer in excess of \$1,000. Review approximate dollar value in dispute and determine the potential impact on capital.

8. Determine that the firm has transmitted to NFA copies of all options customer complaints that would result in an adjustment to the customer's account of more than \$1,000, as well as copies of the dispositions of each such option complaint.
9. Determine if there is any pending litigation resulting from options customer complaints.
 - a) Federal or State courts
 - b) CFIC Reparations
 - c) Arbitration Proceedings
- 10) Review options customer complaints for any trends, repetitive complaints, or numerous complaints against particular salespersons, and note any findings in this area.
- 11) Determine whether the firm is acting upon complaints and resolving such matters within a reasonable amount of time.
- 12) Determine what, if any, disciplinary action(s) have been taken by the firm against any employee, associate, agent, etc. which was the result of an option customers complaint or litigation resulting from such a complaint. Insure that proper notification was given to NFA .

MAR 24 1983

COMMODITY FUTURES TRADING COMMISSION

Registered Futures Associations; Exchange-Traded Commodity Options;
Notice of Commission Approval of Rules

AGENCY: Commodity Futures Trading Commission

ACTION: Notice of Approval of Registered Futures Association Rules

SUMMARY: The Commission is publishing this Notice in order to inform the public that the Commission has approved rules of the National Futures Association ("NFA") a registered futures association, by which NFA will regulate the purchase and sale of exchange-traded commodity option contracts by its members. Under Commission regulations governing the purchase and sale of exchange-traded commodity options, only a Futures Commission Merchant ("FCM") which is a member of the particular exchange on which the option it is purchasing or selling is traded may solicit or accept option orders, unless the FCM is a member of a futures association registered by the Commission which has adopted rules approved by the Commission and which has determined to provide for regulation of the commodity option related activity of its members in a manner equivalent to that required of contract markets under Commission regulations. Commission approval of NFA's compliance rules governing options transactions of NFA members will thus allow NFA members which are not members of a contract market to solicit and accept orders for the purchase and sale of exchange-traded commodity options, or to supervise persons so engaged.

EFFECTIVE DATE: [insert date of publication]

FOR FURTHER INFORMATION CONTACT:

Karen Matteson, Attorney Advisor, Division of Trading and Markets, Commodity Futures Trading Commission, 2033 K Street, N.W., Washington, D.C. 20581,
Telephone: (202) 254-8955.

SUPPLEMENTARY INFORMATION:

Commission regulation 33.3(b) (1) prohibits any person from soliciting or accepting orders for the purchase or sale of any commodity option, or supervising any person so engaged, unless the person is registered as an FCM under the Commodity Exchange Act ("Act") and is either a member of the contract market upon which the option is traded or a member of a futures association registered by the Commission pursuant to section 17 of the Act which has adopted rules which the Commission has approved pursuant to section 17(j) of the Act, and which has determined to provide for the regulation of commodity option related activity of its members in a manner equivalent to that required of contract markets under Commission regulations.

NFA has submitted, and the Commission has approved, pursuant to section 17(j) of the Act, NFA Compliance Rules 2-15 through 2-21, which provide for NFA's regulation of its FCM members engaged in the transactions involving exchange-traded commodity options. Rules 2-15 through 2-20 set forth requirements governing sales practices of FCMs transacting options business, and conform to the requirements imposed upon contract markets pursuant to Part 33 of the Commission's regulations^{1/} as set forth in the table below:

<u>Commission Regulation</u>	<u>Requirement</u>	<u>NFA Rule</u>
33.4 (a) (2)	Full payment of premiums	2-17
33.4 (b) (2)	Deep-out-of-the-money options	2-15(c)
33.4 (b) (3)	Exercise notification to grantor	2-15 (b)

^{1/} NFA Compliance Rule 2-21, which has also been approved by the Commission, requires NFA members desiring to trade options to submit certain materials to NFA ten days prior to beginning to transact options-related business.

<u>Commission Regulation</u>	<u>Requirement</u>	<u>NFA Rule</u>
33.4 (b) (4)	Customer complaints; records	2-18
33.4 (b) (5)	FCM supervisory procedures	2-15 (a)
33.4 (b) (6)	Notice of disciplinary actions	2-19 (a)
33.4 (b) (7)	Enforcement of disclosure requirements	2-19 (b)
33.4 (b) (8)	Submission of promotional material	2-19 (c)
33.4 (b) (9)	Discretionary accounts	2-20
33.4 (b) (10)	Sales communications	2-16

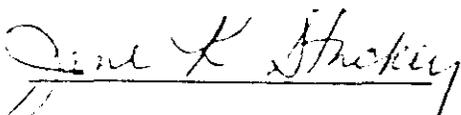
In addition, NFA submitted, and the Commission approved, amendments to NFA Compliance Rule 2-2 which the Commission had stated were necessary prior to its granting authority to NFA to exercise any of the Commission's registration functions or to regulate participants in any exchange-traded commodity options program.^{2/} These amendments will eliminate the words "willful" and "material" from Rule 2-2, which governs fraudulent transactions, where including these terms in the rule results in creation of a standard which renders it more difficult to establish violations of the NFA rule than the corresponding section of the Act. As the Commission noted in its Order, a "willful" standard has been interpreted to include cases in which the person charged with a violation intentionally committed the act constituting the violation, whether or not the person knew he or she was violating the Act,

^{2/} Order Granting Registration and Approving Rules of NFA at 64 (September 22, 1981). These rule changes were necessary in order for NFA to be in compliance with 17 C.F.R. §170.1, which requires that a registered futures association ensure that its members adhere to regulatory requirements at least as stringent as those imposed by the Commission.

a Commission regulation, or an NFA rule. The Commission understands that NFA will interpret the "willful" standard of 2-2(c) in this manner.^{3/}

Finally, NFA has submitted two Delegation Plans under 17 C.F.R. §1.52(c) pursuant to which NFA will perform financial and sales practice audits of NFA members dealing in exchange-traded commodity options which are not members of any contract market.^{4/} The Commission has therefore concluded that NFA has determined to provide for the regulation of the commodity option related activities of its members in a manner equivalent to that required of contract markets by Commission regulations. Thus, those FCMs which are members of NFA are now authorized under the Commission's options pilot program to solicit or accept options orders, or supervise persons so engaged, pursuant to 17 C.F.R. §33.3(b) (1) (i) (B).

Issued in Washington, D.C. on March 21, 1983, by the Commission.


Jane K. Stuckey
Secretary of the Commission

^{3/} Id. at 63 n. 183.

^{4/} These Plans have been published for comment by the Commission. 48 Fed. Reg. 9682 (March 8, 1983). The Plans will ensure that all FCMs will be audited for compliance with Commission, contract market, and NFA requirements governing exchange-traded options by either a contract market or NFA.

February 3, 1983

Mr. Theodore W. Urban
Deputy Director
Division of Trading and Markets
Commodity Futures Trading Commission
2033 K Street, N.W.
Washington, D.C. 20581

Dear Ted:

In connection with the CFIC's review of the proposed NFA option rules and audit procedures adopted pursuant to Part 33 of the CFIC Rules and contained in our letter of December 6, 1982, you raised several questions. This letter is intended to set forth NFA staff's response to those questions in order to facilitate their resolution.

First, you raised the question whether NFA is capable of enforcing its option rules and conducting sales practice audits of those FCMs for which NFA's auditing responsibilities will not be delegated to another self-regulatory organization. As we pointed out in the submission of December 6, 1982, NFA has assembled an experienced and capable staff (see attached biographies). We have drawn experienced talent from the futures and securities exchanges, the futures industry, the private accounting sector and the CFIC. Six staff members hold CPA certificates and many more are currently completing the requirements for certification. NFA currently has a Compliance Department staff of 35 and we expect that staffing level to increase by at least 50% during the next several months. We are at present conducting audits and financial surveillance of futures commission merchants that are not members of any contract market and commodity pool operators. In developing the audit programs in these areas and the option sales practice programs, we have utilized and drawn from the programs of the Commission and various commodity exchanges. In addition, we have utilized the broad experience



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of NFA's staff to expand upon those programs. Consequently, we strongly believe that NFA has the necessary manpower, expertise and programs to provide effective regulation in the area of exchange-traded option activities in addition to the areas where we have already assumed responsibility.

Your second comment concerned whether NFA currently has a program for the regulation of sales practices of NFA Members in their general futures business parallel to the options program contained in our December 6, 1982 submission. We believe that the specific reason for adoption of the proposed option rules does not apply in the general futures sales practice area and that NFA's current rules, as approved by the CFTC, provide an adequate framework for the establishment of appropriate standards parallel to those contained in the option rules.

Many of the specific requirements and proscriptions contained in NFA's proposed option rules are included because they are required under the special regulatory scheme set forth in Part 33 of the CFTC's Rules. It is clear that the CFTC's specific regulatory responsibilities in the option field are treated separately, under Section 4c of the Act, from its other duties. Pursuant to Section 4c, the CFTC carefully constructed special pilot program rules which differ substantially from the general rules governing futures transactions both in the requirements placed upon FCMs and in the duties imposed upon self-regulatory organizations. In response NFA assembled a regulatory program in the option area which corresponds to the specific regulatory scheme established by the CFTC. We do not, however, believe that it is necessary or appropriate for NFA to expand the scope of those rules beyond the specific purposes for which they were required.

Under CFTC Rule 170.5 NFA is required to establish a customer protection program. As the CFTC recognized in the Order Granting Registration and Approving Rules dated September 22, 1981 ("Registration Order"): "In response to these requirements,



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the NFA has adopted a package of compliance rules which establish standards for the business conduct of its members and will form the basis of the NFA's substantive regulation of its members." Registration Order at 61. These rules include the following:

Compliance Rule 2-2 which prohibits fraud, bucket shop activities, the making of false reports or false records, dissemination of false information affecting commodity prices, engaging in manipulative activities, trading for a person under a CFTC trading ban and the embezzlement or conversion of customer funds;

Compliance Rule 2-3 which prohibits sharing in customers' profits or losses without written authority;

Compliance Rule 2-6 which prohibits dealing with a suspended Member;

Compliance Rule 2-8 which regulates the handling of discretionary accounts;

Compliance Rule 2-9 which affirmatively requires each Member to diligently supervise its employees and agents;

Compliance Rule 2-10 which requires maintenance of adequate books and records;

NFA Financial Requirements which set forth rules designed to ensure the financial responsibility of FCM Members and to protect customer funds; and

Compliance Rule 2-4 which generally requires NFA Members to "observe high standards of commercial honor and just and equitable principles of trade."

In addition to the foregoing rules, all of which were part of NFA's Bylaws when NFA was registered, NFA has adopted and obtained CFTC approval of Compliance Rule 2-13 which makes it a violation of an NFA requirement for any NFA Member to violate any of CFTC Rules 4.16 through 4.41. Those rules, pertaining to CPOs and CTAs, deal extensively with sales practice and customer protection issues.



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These rules, taken together, provide a complete regulatory framework within which the NFA Compliance Director may investigate and the Regional Business Conduct Committees may consider and prescribe discipline for any improper conduct of any NFA Member or Associate which is connected in any way to its relationship with or treatment of customers. For example, fraudulent or high pressure sales communications may be investigated and punished under Compliance Rules 2-2, 2-4, and 2-9; failure to have adequate procedures to supervise associated persons in the handling of accounts may be investigated and punished under Compliance Rule 2-9; deceptive representations concerning performance in an FCM trading program may be investigated and punished under Compliance Rules 2-2, 2-4 and 2-9 with reference to the standards set forth in CFIC Rule 4.41 which has been "incorporated" by NFA; and any violation of CFIC Rules 4.16 through 4.41 may be investigated and punished by NFA under Compliance Rule 2-13.

In addition to the regulatory framework supplied by NFA's existing rules, NFA's compliance audit programs have been designed to facilitate regulation of the general sales practices of NFA Members in a manner which is substantially equivalent to the program under NFA's proposed option rules.

Specifically, FCMs are audited in a number of areas relating to customer protection and sales practices. Included in these areas are the following:

Discretionary Accounts. Accounts are tested to determine whether the Member is complying with NFA's discretionary account rules and to determine whether there is evidence of excessive trading in the accounts.

Customer Accounts. Account opening forms are examined to ensure that proper documentation is obtained from customers (e.g. disclosure statement acknowledgments).

Customer Complaints. A review is conducted to evaluate a firm's handling of customer complaints. This program will enable NFA to determine whether a firm is following proper supervision and internal



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control procedures and will aid in identifying particular types of improper conduct such as use of fraudulent or high pressure sales communications.

Customer Orders. An analysis of a firm's customer order flow system is conducted to determine whether all CFTC and NFA requirements are met and to evaluate the integrity of the order flow system.

Margins. Although NFA plays no role in establishing the level of margins, a review and analysis of a firm's margin procedures is performed to determine that the applicable minimums are maintained for the ultimate benefit and protection of customers.

In addition, NFA has developed compliance audit programs for CPD and CTA Members which are designed to closely examine sales practices and promote customer protection.

Nowhere in the Act (including Section 17(p)), in CFTC Rules or in the Registration Order is there any requirement that NFA by rule prescribe the conduct of its Members to any specific level of detail. NFA is only required to have rules which enable it to police the sales practices and business ethics of its Members. As the CFTC has previously found, NFA's existing rules satisfy the pertinent existing requirements. That those rules may lack the detail of the proposed option rules is not due to any deficiency in existing NFA rules. Rather it is due to the fact that the option rules were drafted in the context of special requirements.

As a self-regulatory organization NFA must ground its rulemaking either on the specific requirements of the Act or CFTC Rules or on the judgment of the Board of Directors as to the nature of just and equitable conduct. Although the Board may prescribe certain general rules outside of a specific factual context, as a general proposition detailed standards of conduct must evolve under NFA rules (and may, thereafter, be codified in those rules) as specific cases are decided by the Members' peers in the futures industry. This approach makes sense because the concept of self-regulation requires that detailed standards reflect informed judgment concerning business ethics -- a judgment which cannot properly be made in a factual vacuum. Furthermore, detailed rules which are not either required or



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based on actual regulatory experience may be subject to the criticism that they are arbitrary and competitively oppressive to some NFA Members.

In any event the question whether NFA must adopt additional rules in order to be required to "establish minimum standards governing the sales practices of its members and persons associated therewith . . ." is not strictly relevant to, and need not be decided in connection with the CFTC's consideration of NFA's proposed options regulatory program. New Section 17(p) of the Act requires this issue to be finally resolved within ninety days of the date of enactment of the Futures Trading Act of 1982. It will be time enough for the CFTC and NFA to come to an understanding on this issue in connection with the satisfaction of the duties imposed on NFA and the CFTC under new Section 17(p).

Your third point dealt with the concerns expressed in the Registration Order about NFA Compliance Rule 2-2. In order to allay those concerns NFA staff will recommend to the Board at its meeting on February 17, 1983 that Compliance Rule 2-2 be amended by deleting the word "willfully" both times which it appears in subsection (a) and by deleting the word "materially" each time it appears in subsections (c) and (d). We believe that such amendments will satisfy the requirement under CFTC Rule 170.1 that NFA "require its members to adhere to regulatory requirements governing their business practices at least as stringent as those imposed by the Commission."

We do not believe that the word "willfully" should be deleted from subsections (c) or (d) of Compliance Rule 2-2 in order to meet the requirement of CFTC Rule 170.1. The Registration Order at 64 cites a "variance" from Section 5(c) of the Act as the reason for believing that the willfulness standard should be eliminated from subsection (c). However, neither subsection (c) nor subsection (d) is or could be intended to be an NFA requirement "at least as stringent" as Section 5(c) of the Act. That section is directed toward contract markets and NFA's Articles of Incorporation, as approved by the CFTC, prohibit NFA from prescribing any rule which purports to govern "[t]he content, interpretation, administration or enforcement of any rule...of a contract market." Instead, subsection (c) of Compliance Rule 2-2 is intended to be the NFA analogue of Section



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4b(B) and subsection (d) is intended to be the analogue to the relevant provisions of Section 9(b) of the Act. The willfulness standard is appropriate since both Section 4b(B) and Section 9(b) of the Act include a standard of willfulness analogous to that contained in subsections (c) and (d).

We hope that the foregoing adequately addresses your concerns in reviewing NFA's proposed options regulatory program. If you have any questions or comments please do not hesitate to call.

Very truly yours,

A handwritten signature in black ink, appearing to read "J. Harrison, Jr.", is written over a horizontal line.

Joseph H. Harrison, Jr.
General Counsel

JHH:cv
Enclosure
cc: Andrea M. Corcoran

UNITED STATES OF AMERICA
COMMODITY FUTURES TRADING COMMISSION

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



MAR 24 1983

March 21, 1983

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

Re: NFA Compliance Rules 2-15 through 2-21 and Amendments
to Compliance Rule 2-2

Dear Mr. Harrison:

By letters dated December 6, 1982 and March 9, 1983, NFA submitted the above rules and amendments for Commission approval pursuant to section 17(j) of the Act. The Commission approved the new rules and amendments on March 21, 1983 and also determined that they may be placed into effect immediately.

The Commission also approved publication of the enclosed Federal Register release, which notifies the public that nonexchange member FCMs who are NFA members may now solicit and accept options orders under 17 C.F.R. §33.3(b) (1) (i) (B).

Very truly yours,

Jane K. Stuckey

Jane K. Stuckey
Secretary of the Commission

Enclosure