

May 22, 2013

**Via Federal Express**

Mr. Christopher J. Kirkpatrick  
Deputy Secretary  
Office of the Secretariat  
Commodity Futures Trading Commission  
Three Lafayette Centre  
1155 21st Street, N.W.  
Washington, DC 20581

Re: National Futures Association: FCM Internal Control Systems - Proposed  
Adoption of the Interpretive Notice to NFA Compliance Rule 2-9

Dear Mr. Kirkpatrick:

Pursuant to Section 17(j) of the Commodity Exchange Act, as amended, National Futures Association ("NFA") hereby submits to the Commodity Futures Trading Commission ("CFTC" or "Commission") the proposed adoption of the Interpretive Notice to NFA Compliance Rule 2-9 regarding FCM Internal Control Systems. NFA's Board of Directors ("Board") approved the proposal on May 16, 2013, and NFA respectfully requests Commission review and approval of the proposal.

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**PROPOSED AMENDMENTS  
(additions are underscored)**

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**INTERPRETIVE NOTICES**

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**COMPLIANCE RULES**

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**COMPLIANCE RULE 2-9: FCM INTERNAL CONTROL SYSTEMS**

NFA's Board of Directors (Board) believes it appropriate to provide guidance regarding FCM internal controls, which are a key aspect of an FCM's risk management system. This guidance is provided pursuant to NFA Compliance Rule 2-9, which places a continuing obligation on every Member to diligently supervise its employees and agents in all aspects of their futures activities for or on behalf of the Member. In order to meet this obligation, the Board has determined that each FCM Member must implement an

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internal control system that is designed to provide reasonable assurance that the Member's books and records are current and accurate so that the Member's financial reports are reliable, and that the Member is in compliance with all CFTC, NFA, and where applicable, other self-regulatory organization requirements.

NFA recognizes that, given the differences in the size of and complexity of the operations of FCM Members, there must be some degree of flexibility in determining what constitutes an appropriate internal control system. However, the Board believes that in implementing an internal control system each FCM must at a minimum consider certain factors including its business lines, its firm trading activities, the make-up of its customer base, the markets traded by its customers and the firm, limitations of its own infrastructure, as well as the business of its affiliates. The Board also believes that an internal control system must address certain areas and cover certain specific minimum standards. Therefore, the Board is issuing this Interpretive Notice to highlight certain areas and provide guidance on minimum standards applicable to each area. Each FCM must, however, conduct its own review to identify any other areas that should be included in the firm's internal control system based on the firm's operations and activities.

## **WRITTEN POLICIES AND PROCEDURES**

Each FCM should also have written policies and procedures that explain fully the FCM's internal control system, and describe the FCM's supervisory system that is reasonably designed to ensure that the policies and procedures are diligently followed,<sup>1</sup> and must identify (by title) at least one firm principal who is responsible for overseeing that the firm has met the requirements set forth in this notice and can respond promptly to regulatory inquiries. For example, with respect to the internal controls over customer segregated funds, secured amount funds and cleared swaps customer collateral, the policies and procedures should describe the manner in which the firm monitors the

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<sup>1</sup> There is no requirement that FCMs have a single policy and procedures manual for internal controls. FCMs have discretion on how to organize these policies and procedures and are permitted to have separate policies and procedures addressing the internal control areas discussed in this notice provided the FCM is able to produce a full set of policies and procedures at the request of NFA, its DSRO and/or CFTC.

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impact of market volatility on excess segregated funds, secured amount funds and cleared swaps customer collateral. Similarly, with respect to risk management and trading practices, the policies and procedures should describe the firm's due diligence procedures used to assess customer risk before establishing a relationship. It is not sufficient for the policies and procedures to merely state, for example, that the FCM will monitor a certain area or has particular automated controls to do so.

### **FIRM APPROVAL**

The policies and procedures, and any material amendments thereto, that explain fully the internal control system must be approved in writing by the FCM's Governing Body<sup>2</sup>, Chief Executive Officer, Chief Financial Officer, Chief Operating Officer, Chief Compliance Officer or other individual who is listed as a principal on the FCM's Form 7-R and who either holds a position with knowledge of the FCM's financial requirements and financial position or is an officer that is specifically granted the authority and responsibility to fulfill the requirements of senior management by the Governing Body. In approving the FCM's internal control system and policies and procedures, the approving person may rely on representations from other applicable senior management responsible for particular areas. An FCM's senior management must fully support the internal control system and shall not override the firm's internal control system unless there are exigent circumstances that necessitate that the controls be overridden. Each firm should have an escalation policy in place for employees to report to an FCM's senior management, other firm designated reporting group or individual and/or the firm's regulators if they believe individuals have attempted to improperly override the firm's internal control system in any respect.

The internal control system must address an adequate system of separation of duties; the firm's procedures for complying with customer segregated funds, secured amount funds and cleared swaps customer collateral requirements; establishing and complying with appropriate risk management and trading practices; restrictions on access to

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<sup>2</sup> Governing Body means proprietor if FCM is a sole proprietorship; general partner if the FCM is a partnership; board of directors if the FCM is a corporation; Member(s) vested with management authority if the FCM is a LLC or LLP.

communication and information systems; and monitoring for capital compliance. Set forth below are minimum requirements for each of these areas.

## **INTERNAL CONTROL SYSTEM**

### **Separation of Duties**

Each FCM's internal control system should be designed to ensure appropriate segregation of duties designed to ensure that no single employee is in a position to carry out and conceal errors or fraud or have control over any two phases of a transaction or operation that are covered by this Interpretive Notice. In general, persons who perform the day-to-day functions in areas involving the handling of customer funds, firm trading activities, financial records, risk management, trading practices, and the sales function should be different from the persons who supervise those functions. In those instances where supervisors also handle day-to-day functions, a firm principal or other appropriate supervisory person should periodically review the supervisor's work in material areas.

At a minimum, in addressing a separation of duties, a firm's internal controls should require that:

- The FCM assigns duties to different employees in a manner, or has appropriate automated controls, that ensure that there is cross-checking of the work performed in material areas;
- Operational functions relating to the custody of firm assets should be separated from financial reporting functions such as recordkeeping/accounting for the assets;
- In the customer funds area (e.g., the deposit, maintenance, and distribution), no one person should be responsible for initiating a transaction, approving the transaction, recording the transaction and reconciling the account to third party documentation and information;

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- Personnel who are employed in the firm's compliance, risk management, or other control unit(s) who monitor firm trading activities from a compliance and risk perspective should not be subject to the supervision or control of those placing the trades, and their compensation should not be directly tied to the trading performance of the firm's trading activities; and
- Personnel who are employed in the firm's compliance, risk management, or other control unit(s) who have responsibility to perform due diligence functions with respect to approving customer accounts and establishing account trading limits and risk parameters should not be subject to the supervision or control of sales persons whose compensation may be directly tied to the trading done by the customer.

### **Customer Segregated Funds, Secured Amount Funds and Cleared Swaps Collateral**

Each FCMs internal control system must be designed to provide reasonable assurance that the firm is continually in compliance with the requirements related to customer segregated funds, customer secured amount funds and cleared swaps customer collateral and has appropriate controls in place to safeguard customer and firm assets. Among other things, these controls should be designed to ensure:

- All customer segregated funds, secured amount funds and cleared swaps customer collateral accounts are appropriately titled and the firm has obtained the required acknowledgement letter from the bank, trust company, other FCM or clearing organization (as applicable) with custody of the funds;
- Customer segregated accounts, customer secured amount accounts and cleared swap customer collateral accounts are reconciled on a daily basis in order to ensure that the FCM can properly complete a daily segregated customer funds account computation, a daily customer secured amount funds computation and a daily cleared swaps customer collateral computation (as applicable) prior to noon of the next business day pursuant to NFA Financial Requirements Section 16;

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- The firm's procedures for investing customer segregated funds, customer secured amount funds and cleared swaps customer collateral is in accordance with CFTC Regulation 1.25;
- The firm adequately monitors daily variances, including those caused by intra-day market volatility, with respect to pre-determined thresholds (e.g., the targeted residual interest pursuant to Financial Requirements Section 16) in excess segregated funds, secured amount funds and cleared swaps customer collateral;
- Disbursements from customer segregated funds, customer secured amount funds and cleared swaps customer collateral are not made without the required approvals and verifications, including if applicable those approvals and notices required by NFA Financial Requirements Section 16;
- The firm adequately monitors transfers from customer segregated funds, secured amount funds and cleared swaps customer collateral to ensure that it remains in compliance with its segregated funds, secured amount funds and cleared swaps customer collateral requirements on an intra-day basis;
- The firm has procedures in place reasonably designed to ensure that all transactions related to customer funds are timely recorded; and
- The firm has controls in place that are designed to provide reasonable assurance to protect against the unauthorized acquisition, use or disposal of assets.

### **Risk Management and Trading Practices**

Key to an effective internal control system is identifying the risks to the FCM's business and developing controls to monitor and address those risks. For an FCM's business, the trading activity carried out through the firm is one of its highest risks. FCMs should have risk management programs that emphasize the importance of the firm's business or trading desk supervisors playing a direct and primary role in monitoring the risks posed by their particular areas. In addition, at a minimum, an FCM must have controls, appropriate to the FCM in light of its business operations and functions, over the following areas:

- Due diligence procedures to assess each customer's risks prior to establishing a customer relationship (does not apply to execution only relationships);
- Monitoring of the risks associated with accepting a particular trade from a particular customer, including give-ups;
- Use of risk based limits for firm accounts and each customer and non-customer account based on position size, order size, margin requirements or similar factors;
- Monitoring of the risks associated with firm and non-customer trades;
- Use of stress testing and pre-determined position/credit limits to minimize the impact of significant market moves;
- Monitoring of customer account activity and adherence to risk based limits on both an intra-day and overnight basis;
- Margin practices for both customers and non-customers that address establishing margin levels; collecting additional margin requirements; handling intra-day margin calls; accepting or monitoring collateral; restrictions on trading in an under-margined account; and reviewing debit/deficit accounts;
- Use of automated means (e.g., credit controls or position limits) to screen both customer and non-customer orders for compliance with risk based limits when providing electronic market access or accepting orders for automated execution;
- Use of methods and procedures reasonably designed to ensure compliance with risk based limits when accepting orders for non-automated execution; and
- Adequate sources of FCM liquidity in the event of increased settlement obligations.

### **Restrictions on Access to Information and Communication Systems**

Firms should establish controls over the information and communication systems used to initiate, authorize, record, process and report transactions used in areas relating to customer segregated funds, the firm's capital compliance, financial reporting, risk management and trading. An FCM should establish control and monitoring activities that cover, at a minimum, the following:

- Ensuring that systems and technical personnel can support program changes in the relevant systems and any upgrades as needed;
- Restricting access to systems used to initiate, authorize, record, process and report transactions to authorized personnel using logical access controls such as passwords;
- Restricting trade, commission or data correction access in back office systems to appropriate personnel;
- Restricting access to authorized personnel to enter orders for firm trading and customer accounts; and
- Restricting access to and establishing other controls over changes in account information such as name, address, commission rates and type of account.

### **Capital Compliance**

It is essential for an FCM to be continuously in compliance with its regulatory capital requirements. In order to ensure this compliance, an FCM must have appropriate internal controls designed to provide reasonable assurance that its financial information is accurate and up-to-date and that any capital withdrawals are properly monitored and approved. At a minimum, the FCM must have controls, appropriate to the FCM in light of its business operations and functions, in the following areas:



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- Monitoring of intra-month capital position;
- The mapping, netting and adjustments to monthly GAAP financial statement line items to required regulatory computations;
- Changes to any key calculations that are used to compile other charges used in computations;
- The timely recording of any transactions relating to the firm's capital position; and
- Approvals over capital withdrawals, including in accordance with notification requirements under CFTC Regulation 1.12.

### **REVIEW OF INTERNAL CONTROL SYSTEM**

In addition to establishing an internal control system over these areas, and developing policies and procedures that fully describe the system, each FCM must do periodic reviews to ensure that the internal controls are being implemented properly and are effective. The policies and procedures should describe the process for determining the frequency and scope of the reviews, which may be established on a risk based approach. Additionally, to the extent an FCM performs a review of its risk management program as required by CFTC Regulations, then the FCM should take into account the scope, frequency and results of these reviews in determining the frequency and scope of any further review of its internal controls system. This review must be documented and should be conducted by persons independent from those individuals responsible for implementing the controls. In determining whether the internal controls are being implemented and are effective, the persons conducting the review may rely on other employees, outside consultants, lawyers and accountants.

This Interpretive Notice is intended to specify minimum standards for an FCM's internal controls system. A failure to adhere to this Notice will be deemed a violation of NFA Compliance Rule 2-9.

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**EXPLANATION OF PROPOSED AMENDMENTS**

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FCM internal controls are a key aspect of an FCM's risk management system. NFA's Board has determined that it is appropriate to provide guidance to FCMs through an Interpretive Notice that outlines the minimum standards that should be a part of any FCM's internal controls system. In developing this Interpretive Notice, the Board was guided by the overarching principle that an FCM's internal control system should be designed to provide reasonable assurance that the Member's books and records are current and accurate so that the Member's financial reports are reliable, and that the Member is in compliance with all CFTC, NFA, and where applicable, other self-regulatory organization requirements.

The Interpretive Notice acknowledges that given the differences in the size and complexity of the operation of FCM Members, there must be some degree of flexibility in determining what constitutes an appropriate internal control system. Nevertheless, the Interpretive Notice requires all FCMs to consider certain factors including its business lines, its firm trading activities, the make-up of its customer base, the markets traded by its customers and the firm, limitations on its own infrastructure, as well as the business of its affiliates. In addition, the Interpretive Notice requires that an FCM's internal control system address an adequate system of separation of duties; the firm's procedures for complying with customer segregated funds, secured amount funds and cleared swap customer collateral requirements; establishing and complying with appropriate risk management and trading practices; restrictions on access to communication and information systems; and monitoring for capital compliance. The Interpretive Notice identifies the minimum requirements for each of these areas.

Under the Interpretive Notice, FCMs are required to have written policies and procedures that explain fully the FCM's internal control system, and describe the FCMs supervisory system that is reasonably designed to ensure that the policies and procedures are diligently followed, and must identify (by title) at least one firm principal who is responsible for overseeing that the firm has met the requirements set forth in the notice and can respond promptly to regulatory inquiries. The Interpretive Notice also requires that these written policies and procedures, and any material amendments, be approved in writing by the FCM's Governing Body, Chief Executive Officer, Chief

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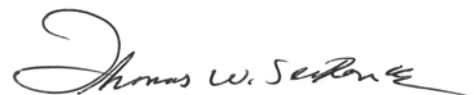
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Financial Officer, Chief Operating Officer, Chief Compliance Officer or other individual who is listed on the FCM's Form 7-R and who either holds a position with knowledge of the FCM's financial requirements and financial position or is an officer that is specifically granted the authority and responsibility to fulfill the requirements of senior management by the Governing Body. Finally the Interpretive Notice requires each FCM to do periodic reviews to ensure that the internal controls are being implemented properly and are effective.

In developing this Notice, NFA worked closely with representatives from CME Group, Inc., and obtained comments and suggestions from NFA's FCM Advisory Committee, the Futures Industry Association's Financial Management Committee and several prominent public accounting firms that are involved in the required annual certified audits of FCMs. NFA also considered the CFTC's current proposed rules on customer protection enhancements that were published in the Federal Register on November 14, 2012.

NFA respectfully requests that the Commission review and approve the Interpretive Notice to NFA Compliance Rule 2-9 regarding FCM Internal Control Systems.

Respectfully submitted,

A handwritten signature in black ink, appearing to read "Thomas W. Sexton". The signature is fluid and cursive, with a long horizontal stroke at the end.

Thomas W. Sexton  
Senior Vice President and  
General Counsel