

By the Commission.

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Deputy Secretary.

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## SECURITIES AND EXCHANGE COMMISSION

[Release No. 34-44823; File No. SR-NFA-2001-01]

### Self-Regulatory Organization; Notice of Filing and Immediate Effectiveness of Proposed Rule Change by National Futures Association Relating to Security Futures Products

September 20, 2001.

Pursuant to Section 19(b)(7) of the Securities Exchange Act of 1934 ("Exchange Act"),<sup>1</sup> and Rule 19b-7 under the Exchange Act,<sup>2</sup> notice is hereby given that on August 21, 2001, the National Futures Association ("NFA") filed with the Securities and Exchange Commission ("SEC" or "Commission") the proposed rule change described in Items I, II, III below, which Items have been prepared by NFA. The Commission is publishing this notice to solicit comments on the proposed rule change from interested persons.

On July 20, 2001, the NFA submitted the proposed rule change to the Commodity Futures Trading Commission ("CFTC") for approval. The CFTC approved the proposed rule change on August 20, 2001.<sup>3</sup>

#### I. Self-Regulatory Organization's Description of the Proposed Rule Change

The Commodity Futures Modernization Act of 2000 ("CFMA") amended Section 15A of the Exchange Act to add new subsection (k),<sup>4</sup> which makes NFA a national securities association for the limited purpose of

regulating the activities of NFA Members who are registered as brokers or dealers in security futures products under Section 15(b)(11) of the Exchange Act.<sup>5</sup> The most significant provisions of the proposed rule change would make the requirements that apply to the security futures activities of these NFA Members reasonably comparable to those that apply to NASD members,<sup>6</sup> as required by Section 15(k)(2) of the Exchange Act.<sup>7</sup>

#### II. Self-Regulatory Organization's Statement of the Purpose of, and Statutory Basis for, the Proposed Rule Change

NFA has prepared statements concerning the purpose of, and basis for, the proposed rule change, burdens on competition, and comments received from members, participants, and others. The text of these statements may be examined at the places specified in Item IV below. These statements are set forth in Sections A, B, and C below. The text of the proposed rule change is available at the Office of the Secretary, NFA, and on the Commission's web site (<http://www.sec.gov>).

##### A. Self-Regulatory Organization's Statement of the Purpose of, and Statutory Basis for, the Proposed Rule Change

###### 1. Purpose

The CFMA lifted the 18-year ban on single stock futures and narrow-based security indices (security futures products) and regulates these products as both securities and futures. The CFMA amended Section 15A of the Exchange Act to add new subsection (k),<sup>8</sup> which makes NFA a national securities association for the limited purpose of regulating the activities of NFA Members who are registered as brokers or dealers in security futures products under Section 15(b)(11) of the Exchange Act,<sup>9</sup> which was also added by the CFMA. Section 15A(k)(2)<sup>10</sup> requires NFA to have anti-fraud, anti-manipulation, and customer protection rules reasonably comparable to those of the National Association of Securities Dealers, Inc. ("NASD") for the purpose

of governing the security futures activities of these Section 15(b)(11)<sup>11</sup> broker-dealers.

NFA represents that it already has anti-fraud, anti-manipulation, and customer protection rules that have proven effective in governing the futures activities of NFA Members. However, NFA's rules sometimes take a different approach than NASD's rules and, as a result, they do not correspond in every instance. Therefore, NFA has adopted the proposed rule change in order to ensure that NFA meets the standards imposed by Section 15A(k)(2) of the Exchange Act.<sup>12</sup>

In NFA staff's discussions with SEC staff, SEC staff suggested that NFA's rules should be comparable to those NASD rules that apply to options since both are derivative instruments. SEC staff also told NFA to include those rules that apply to writing options since the risks of futures transactions are more similar to the risks of writing options than to the risks of purchasing them. These principles guided NFA in developing the proposed rule change. A more detailed discussion of the rule change follows.

###### a. Bylaw 1101 (Doing Business With Non-Members)

Bylaw 1101 prohibits NFA Members from doing business with non-Members who are required to be registered with the CFTC as futures commission merchants ("FCMs"), introducing brokers ("IBs"), commodity pool operators ("CPOs"), or commodity trading advisors ("CTAs"). Section 4f(a)(4)(C) of the Commodity Exchange Act ("CEA")<sup>13</sup> provides that registered futures associations may not prohibit their members from doing security futures business with FCMs and IBs registered under Section 4f(a)(2) of the CEA.<sup>14</sup> Bylaw 1101 has been amended accordingly.

###### b. Bylaw 1507, Compliance Rule 1-1, and Code of Arbitration Section 1 (Definitions)

The definition of futures has been amended to include security futures products. The amendments make it clear that NFA has both compliance and arbitration jurisdiction over security futures transactions involving its NFA Members.

Compliance Rule 1-1 has also been amended to add a definition of "Exchange Act," since the Exchange Act

<sup>1</sup> 15 U.S.C. 78s(b)(7).

<sup>2</sup> 17 CFR 240.19b-7.

<sup>3</sup> On August 29, 2001, the NFA submitted a proposed rule change to the CFTC to amend the "Interpretive Notice on Obligation to Customers and Other Market Participants" ("Interpretive Notice") that is included in the instant proposed rule change. On September 7, 2001, pursuant to Section 17(j) of the Commodity Exchange Act, 7 U.S.C. 21(j), the CFTC deemed the proposed rule change to amend the aforementioned Interpretive Notice to be effective. Telephone conversation with Kathryn Camp, Associate General Counsel, NFA, and Marc McKayle and Andrew Shipe, Special Counsel, Division of Market Regulation ("Division"), Commission, on September 13, 2001. On September 18, 2001, the NFA filed a proposed rule change (SR-NFA-2001-02) with the Commission that incorporates the amendment to the Interpretive Notice.

<sup>4</sup> 15 U.S.C. 78o-3(k).

<sup>5</sup> 15 U.S.C. 78o(b)(11)

<sup>6</sup> For purposes of clarity, references to "NASDR," "NASDR members" and "NASDR Conduct Rules" in this notice have been changed to "NASD," "NASD members" and "NASD Rules," respectively. Telephone conversation with Kathryn Camp, Associate General Counsel, NFA, and Nancy Sanow, Assistant Director, and Marc McKayle, Special Counsel, Division, Commission, on September 19, 2001.

<sup>7</sup> 15 U.S.C. 78o-3(k)(2).

<sup>8</sup> 15 U.S.C. 78o-3(k).

<sup>9</sup> 15 U.S.C. 78o(b)(11)

<sup>10</sup> 15 U.S.C. 78o-3(k)(2).

<sup>11</sup> 15 U.S.C. 78o(b)(11).

<sup>12</sup> 15 U.S.C. 78o-3(k)(2).

<sup>13</sup> 7 U.S.C. 6f(a)(4)(C).

<sup>14</sup> 7 U.S.C. 6f(a)(2).

is now referred to in a number of places in the Compliance Rules.

c. Compliance Rule 2-7 (Designated Security Futures Principals)

Proposed Compliance Rule 2-7(b) requires NFA Members who register as broker-dealers under Section 15(b)(11) of the Exchange Act<sup>15</sup> ("passported Members") to designate one or more security futures principals and requires the principal to take the Series 30 examination (for futures branch office managers), which will be updated to include questions regarding supervision of activities involving security futures products.<sup>16</sup> This is comparable to NASD Rule 1022(f), which requires NASD members who engage in options transactions to have at least one registered options principal.

Corresponding changes to Compliance Rules 2-8, 2-29, and 2-30 require a designated security futures principal to review discretionary trades, approve promotional material, and approve customer accounts for security futures transactions.

d. Compliance Rules 2-22 and 2-26

Compliance Rule 2-22 has been amended to prohibit NFA Members from implying that they have been sponsored, recommended, or approved by any federal or state regulatory body. This makes it comparable to NASD Rule 2210(d)(2)(f).

CFTC Regulations 155.3<sup>17</sup> and 155.4<sup>18</sup> dictate the terms under which an associated person ("AP") of one Member can open and trade an account with another Member. Compliance Rule 2-26 has been amended to incorporate these regulations in order to make it comparable to NASD Rule 3050.

e. Compliance Rule 2-29 (Promotional Material)

NFA's and NASD's promotional material rules are comparable for the most part. NASD's rules do, however, contain several requirements that are either not included or not explicitly stated in NFA's rules. The amendments to Compliance Rule 2-29 are intended to make it more like NASD's promotional material rules in the way it applies to promotional material for security futures products.

The amendment to Compliance Rule 2-29(b) adds new subsection (6) regarding testimonials. This requirement is actually stricter than

NASD Rule 2210(d)(2)(D), which is the comparable NASD requirement, since the proposed NFA requirement actually prohibits the use of any testimonial that is not representative of all reasonably comparable accounts.

A new section (j) has been added to be comparable with various requirements in NASD Rules 2210 and 2220. This section applies only to the promotional material of passported NFA Members (and their Associates) that specifically refers to security futures products. Among other things, Compliance Rules 2-29(j):

- Requires promotional material that solicits for a trading program to be managed by an FCM or IB Member to include the cumulative performance history of the Member's customers who have used the trading program or to state that the program is unproven;

- Requires NFA Members to provide customers with supporting documentation, upon request, for any claims, comparisons, recommendations, statistics, and other technical data made in the promotional material;

- Prohibits promotional material from referring to past trading recommendations in security futures products, the underlying securities, or derivatives thereof unless it describes all other recommendations made for similar products over the last year;

- Prohibits promotional material for security futures products from making specific trading recommendations unless the material discloses conflicts of interest based on activities in the underlying security and offers to provide information on all recommendations made for similar products over the last year;

- Provides that promotional material that is not accompanied or preceded by the disclosure statement for security futures products can only contain a general description of security futures products, the name of the NFA Member, and the person to contact for a current disclosure statement; and

- Requires NFA Members to pre-file all mass media advertising that relates to security futures products (unless it merely mentions them as one of the services it offers).

f. Compliance Rule 2-30 (Suitability)

Two statutory provisions effectively require NFA to have suitability rules comparable to those of NASD. First, the suitability requirements are customer protection rules that are included in the requirements for qualification under Section 15A(k) of the Exchange Act.<sup>19</sup> Second, the listing requirements in

Section 2(a)(1)(D)(i)(V) of the CEA<sup>20</sup> essentially bar transactions by FCMs, IBs, CTAs, CPOs, and APs that are not subject to suitability requirements comparable to those of NASD.

NFA Compliance Rule 2-30 requires NFA Members (and their Associates) to obtain information about each customer's experience, income, net worth and age before opening a futures account. It also requires NFA Members to give risk disclosure, with the risk disclosures required by the CFTC as the minimum. Compliance Rule 2-30 requires NFA Members to provide additional risk disclosure if the customer needs it to make an informed judgment about whether he or she should be involved in the futures markets. In fact, if the Member believes that futures are simply too risky for that customer, the Member must tell the customer that he has no business trading futures. This is true even if the Member makes no recommendations whatsoever to the customer. If the customer still decides to trade futures, however, the Member may open the account.

Like NASD requirements, Compliance Rule 2-30 is designed to keep customers from trading futures if they are unsuitable. Unlike NFA Compliance Rule 2-30, however, NASD Rules 2310, 2860(16), 2860(19), and IM-2860-2: (1) require members to obtain more extensive information from natural person customers; (2) require members to specifically approve or disapprove security options accounts based on an evaluation of the customer's suitability to trade those products; and (3) explicitly prohibit members from making unsuitable recommendations. Therefore, NFA has added a new section (j) to Compliance Rule 2-30 to include these requirements for security futures and apply them to NFA Members who are not also NASD members and therefore are not subject to the NASD's suitability requirements).

NFA and a number of other self-regulatory organizations are currently drafting a standardized disclosure statement that must be given to all security futures customers. Compliance Rule 2-30(b) has been revised to require NFA Members to provide this statement when or before an account is approved to trade security futures products.

g. Compliance Rule 2-37 (Security Futures Products)

Compliance Rule 2-37 is an entirely new rule that applies only to the

<sup>15</sup> 15 U.S.C. 78o(b)(11).

<sup>16</sup> Current registrants will not have to take the Series 30 examination if they take an appropriate training course.

<sup>17</sup> 17 CFR 155.3

<sup>18</sup> 18 CFR 155.4

<sup>19</sup> 15 U.S.C. 78o-3(k).

<sup>20</sup> 7 U.S.C. 4(a)(1)(D)(i)(V).

security futures activities of passported NFA Members and their Associates.

- Section 15A(k)(2)(A) of the Exchange Act<sup>21</sup> requires NFA to enforce relevant provisions of the securities laws. Compliance Rule 2-37(a) requires passported NFA Members and their Associates to comply with Sections 9(a), 9(b), and 10(b) of the Exchange Act,<sup>22</sup> and Compliance Rule 2-37(b) requires passported NFA Members to have procedures reasonably designed to achieve compliance with applicable securities laws.

- Compliance Rule 2-37(c) requires passported NFA Members that carry accounts to provide security futures customers with annual information of NFA's BASIC system, which discloses disciplinary information regarding NFA Members and their Associates. This requirement is similar to NASD Rule 2280.

- Compliance Rule 2-37(d)-(f) requires Associate of passported NFA Members to report certain information (e.g., significant customer complaints) to their sponsors and requires those NFA Members to report similar information to NFA. NFA Members also be required to file quarterly reports with NFA containing statistical information about customer complaints received during the quarter. These requirements are comparable to NASD Rule 3070.

#### h. Interpretive Notice Regarding Enhanced Supervisory Requirements

This notice, found at Paragraph 9021 of the National Futures Association Manual, requires enhanced supervisory procedures for firms that have a significant number of Associates who were previously employed at firms closed down for sales practice fraud. Although the notice is generally stricter than NASD Rule 3010(b)(2), which is the comparable NASD requirement, it has been amended to provide that firms must have written supervisory procedures for complying with the requirements for the notice and all applicable provisions of the securities laws and must file quarterly reports with NFA concerning their compliance with the requirements of the notice.

#### i. Interpretive Notice Regarding Obligations to Customers and Other Market Participants

Both NFA and NASD have rules prohibiting their respective members from engaging in conduct inconsistent with just and equitable principles of trade as well as manipulative or fraudulent practices. See NFA Compliance Rules 2-2 and 2-4 and

NASD Rules 2110 and 2120. Nonetheless, several NASD interpretive memoranda explicitly prohibit some specific conduct that has not been explicitly prohibited by NFA rules or interpretive notices. NFA's new interpretive notice explicitly prohibits this conduct.

One of the linchpins of the futures industry is the concept that registrants may not trade ahead of customer orders. Most, if not all, the futures exchanges have rules prohibiting their members from engaging in this conduct, and CFTC Regulations 155.3(a)<sup>23</sup> and 155.4(a)<sup>24</sup> require FCMs and IBs to have and enforce procedures to insure that they and their employees do not trade ahead of customer orders. Although NFA does not have a specific requirement prohibiting NFA Members and Associates from trading ahead of customer orders, NFA has always considered it a violation of Compliance Rule 2-4. However, in order to make NFA rules more comparable to NASD IM-2110-2, NFA has specifically prohibited that conduct in this new interpretive notice. As noted previously, CFTC Regulation 155.3<sup>25</sup> and 155.4<sup>26</sup> have also been incorporated by reference into NFA Compliance Rule 2-26.

This interpretive notice also contains several provisions that apply only to passported NFA Members and their Associates when they engage in security futures activities. These provisions: (1) prohibit trading ahead of research reports (comparable to NASD IM-2110-4); (2) prohibit trading based on knowledge or an imminent block transaction (generally comparable to NASD IM-2110-3), with an exception for hedging counterpart risk under approved exchange block rules; and (3) require a sound basis for evaluating the facts regarding a particular security futures product (comparable to NASD Rule 2210(d)(1)(A)).

#### j. Interpretive Notice Regarding Special Supervisory Requirements for NFA Members Registered as Broker-Dealers Under Section 15(b)(11) of the Exchange Act

Both the NFA and the NASD have extensive requirements regarding supervision. In some areas, however, the NASD's requirements are more detailed than NFA's. Therefore, NFA has adopted a new interpretive notice to NFA Compliance Rule 2-9 (Supervision) regarding Special Supervisory Requirements for Security

Futures Products. The interpretive notice, which applies only to security futures activities by passported NFA Members, is intended to be comparable to various supervisory requirements in NASD Rules 2210(f), 2860(18), 2860(20), and 3010.

Among other things, this interpretive notice requires that:

- A designated security futures principal approves all policies and procedures relating to security futures products;
- Each security futures sales office has a designated security futures principal;
- NFA Members adopt and enforce procedures requiring a designated security futures principal to review correspondence relating to security futures products;
- A designated security futures principal oversees reviews of branch offices and guaranteed IBs that engage in security futures activities, including a yearly on-site audit of each office that engages in security futures activities; and
- NFA Members check securities records as well as futures records when deciding whether to hire an employee or guarantee an IB.

#### k. Interpretive Notice on Use of Past or Projected Performance and Disclosing Conflicts of Interest for Security Futures Products

NFA has also adopted a new interpretive notice to NFA Compliance Rule 2-29 on Use of Past or Project Performance and Disclosing Conflicts of Interest for Security Futures Products. The notice mostly describes positions taken by NFA's Business Conduct Committee and Hearing Panels regarding past and projected performance and is intended to be comparable to some of the specific provisions of NASD Rules 2210 and 2220. It also explains the responsibilities of passported NFA Members under new section (j) of Compliance Rule 2-29.

#### 2. Statutory Basis

The rule change is authorized by, and consistent with, Section 15A(k) of the Exchange Act.<sup>27</sup> The proposed amendments are designed to make NFA's rules correspond more closely to NASD's rules, as is contemplated by Section 15A(k) of the Exchange Act.

#### B. Self-Regulatory Organization's Statement on Burden on Competition

The rule change will not impose any burden on competition that is not

<sup>21</sup> 15 U.S.C. 78o-3(k)(2)(A).

<sup>22</sup> 15 U.S.C. 78i(a), 78i(b), and 78j(b).

<sup>23</sup> 17 CFR 155.3(a).

<sup>24</sup> 17 CFR 155.4(a).

<sup>25</sup> 17 CFR 155.3.

<sup>26</sup> 17 CFR 155.4.

<sup>27</sup> 15 U.S.C. 78o-3(k).

necessary or appropriate in furtherance of the purposes of the Exchange Act and the CEA, as they were amended by the CFMA. In fact, the CFMA is designed to promote an even regulatory playing field among securities and futures registrants—and among NFA members and NASD members—so that neither group has a competitive advantage over the other. NFA's rule change achieves that objective.

*C. Self-Regulatory Organization's Statement of Comments on the Proposed Rule Change Received From Members, Participants, or Others*

NFA worked with Member committees and industry trade associations in developing the rule change. NFA did not, however, publish the rule change for comment by its membership. NFA received one written comment letter from an industry trade association, which generally supported the rule change.

**III. Date of Effectiveness of the Proposed Rule Change and Timing for Commission Action**

The proposed rule change has become effective on August 20, 2001, which is the date of approval of the proposed rule change by the CFTC.

Within 60 days of the date of effectiveness of the proposed rule change, the Commission, after consultation with the CFTC, may summarily abrogate the proposed rule change and require that the proposed rule change be refiled in accordance with the provisions of Section 19(b)(1) of the Exchange Act.<sup>28</sup>

**IV. Solicitation of Comments**

Interested persons are invited to submit written data, views and arguments concerning the foregoing, including whether the proposed rule change conflicts with the Exchange Act. Persons making written submissions should file nine copies of the submission with the Secretary, Securities and Exchange Commission, 450 Fifth Street, NW., Washington, DC 20549-0609. Comments also may be submitted electronically to the following e-mail address: *rule-comments@sec.gov*. Copies of the submission, all subsequent amendments, all written statements with respect to the proposed rule change that are filed with the Commission, and all written communications relating to the proposed rule change between the Commission and any person, other than those that may be withheld from the

public in accordance with the provisions of 5 U.S.C. 552, will be available for inspection and copying in the Commission's Public Reference Room. Copies of these filings also will be available for inspection and copying at the principal office of NFA. Electronically submitted comments will be posted on the Commission's Internet website (<http://www.sec.gov>). All submissions should refer to File No. SR-NFA-2001-01 and should be submitted by October 18, 2001.

For the Commission, by the Division of Market Regulation, pursuant to delegated authority.<sup>29</sup>

**Margaret H. McFarland,**

*Deputy Secretary.*

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**SECURITIES AND EXCHANGE COMMISSION**

[Release No. 34-44825; File No. SR-NYSE-2001-29]

**Self-Regulatory Organizations; Notice of Filing of Proposed Rule Change by the New York Stock Exchange, Inc. Relating to Eliminating the Exchange's Discretion To Exempt Relief Specialists From Registration and Approval**

September 20, 2001.

Pursuant to Section 19(b)(1) of the Securities Exchange Act of 1934 ("Act")<sup>1</sup> and Rule 19b-4 thereunder,<sup>2</sup> notice is hereby given that on August 21, 2001, the New York Stock Exchange, Inc. ("NYSE" or "Exchange") filed with the Securities and Exchange Commission ("Commission") the proposed rule change as described in Items I, II and III below, which Items have been prepared by the NYSE. The Commission is publishing this notice to solicit comments on the proposed rule change from interested persons.

**I. Self-Regulatory Organization's Statement of the Terms of Substance of the Proposed Rule Change**

The NYSE proposes to amend NYSE Rule 103 (Registration of Specialists) to delete the provision that grants the Exchange the discretion to exempt relief specialists from registration and approval requirements.

<sup>29</sup> 17 CFR 200.30-3(a)(75).

<sup>1</sup> 15 U.S.C. 78s(b)(1).

<sup>2</sup> 17 CFR 240.19b-4.

**II. Self-Regulatory Organization's Statement of the Purpose of, and Statutory Basis for, the Proposed Rule Change**

In its filing with the Commission, the NYSE included statements concerning the purpose of, and basis for, the proposed rule change and discussed any comments it received on the proposed rule change. The text of these statements may be examined at the places specified in Item IV below. The NYSE has prepared summaries, set forth in sections A, B, and C below, of the most significant aspects of such statements.

*A. Self-Regulatory Organization's Statement of the Purpose of, and Statutory Basis for, the Proposed Rule Change*

1. Purpose

The purpose of the proposed rule change is to amend NYSE Rule 103 (Registration of Specialists) to delete the provision that grants the Exchange the discretion of exempt relief specialists from registration and approval requirements.

NYSE Rule 103 requires that members acting as specialists be registered with and approved by the Exchange as such. NYSE Rule 103 provides for exempting relief specialists under conditions that the Exchange may prescribe. However, the Exchange has required and will continue to require the registration and approval of relief specialists in order to help insure that the role of specialist is entrusted to qualified individuals. The Exchange, therefore, proposes to remove the exemptive provision from NYSE Rule 103.

2. Statutory Basis

The Exchange believes that the proposed rule change is consistent with Section 6(b) of the Act,<sup>3</sup> in general, and furthers the objectives of Section 6(b)(5),<sup>4</sup> in particular, because it is designed to promote just and equitable principles of trade, to remove impediments to and perfect the mechanism of a free and open market and a national system and, in general, to protect investors and the public interest.

*B. Self-Regulatory Organization's Statement on Burden on Competition*

The Exchange does not believe that the proposed rule change will impose any inappropriate burden on competition.

<sup>3</sup> 15 U.S.C. 178f(b).

<sup>4</sup> 15 U.S.C. 78f(b)(5).

<sup>28</sup> 15 U.S.C. 78s(b)(1).