

## SECURITIES AND EXCHANGE COMMISSION

[Release No. 34-58709; File No. SR-NFA-2008-02]

### Self-Regulatory Organizations; National Futures Association; Notice of Filing and Immediate Effectiveness of Proposed Rule Change Relating to Technical Amendments to the Interpretive Notice Regarding Compliance Rule 2-9: Enhanced Supervisory Requirements

October 1, 2008.

Pursuant to Section 19b(7) of the Securities Exchange Act of 1934 ("Act"),<sup>1</sup> and Rule 19b-7 under the Act,<sup>2</sup> notice is hereby given that on September 5, 2008, the National Futures Association ("NFA") filed with the Securities and Exchange Commission ("SEC" or "Commission") the proposed rule change described in Items I, II, and III below, which Items have been prepared by the NFA.<sup>3</sup> The Commission is publishing this notice to solicit comments on the proposed rule change from interested persons. NFA also has filed this proposed rule change concurrently with the Commodity Futures Trading Commission ("CFTC").

On September 5, 2008, the NFA requested that the CFTC make a determination that review of the proposed rule change is not necessary. On September 18, 2008, the CFTC notified the NFA that the CFTC has determined not to review the proposed rule change.<sup>4</sup>

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

The NFA's Board of Directors ("Board") adopted two revisions to NFA Compliance Rule 2-9's Interpretive Notice entitled "Enhanced Supervisory Requirements" ("Notice"). The changes include a limited expansion of an existing exemption for some associated persons ("APs") who worked at a Disciplined Firm more than ten years ago from being counted for purposes of calculating whether a Member that hires such an individual is required to adopt the enhanced supervisory procedures. The second change is to the language in the Notice describing the enhanced capital component to change the requirement for Forex Dealer Members

("FDMs") from a fixed amount to 150 percent of their capital requirement to cover recent changes to capital requirements and to make the provision more flexible in addressing future changes to capital requirements.

#### 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.

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

###### 1. Purpose

Section 15A(k) of the Act<sup>5</sup> makes NFA a national securities association for the limited purpose of regulating the activities of NFA Members ("Members") who are registered as brokers or dealers under Section 15(b)(11) of the Act.<sup>6</sup> NFA's Interpretive Notice entitled "Compliance Rule 2-9: Enhanced Supervisory Requirements" applies to all Members who meet the criteria in the Interpretive Notice and could apply to Members registered under Section 15(b)(11).

NFA's Board of Directors first adopted the Notice in January 1993. It requires a Member to undertake enhanced supervisory requirements if its sales force includes a specified number of individuals who have worked at Disciplined Firms, or if a principal of the firm has been a principal of another firm that has been subject to the enhanced supervisory requirements, or, under certain circumstances, when a Member becomes subject to a disciplinary action.

The Board has amended the Notice from time to time based on various changes affecting the membership and on practical lessons learned from administering the Notice. Over the past several years, the Board has recognized that some APs who were counted as having worked at a Disciplined Firm under the original version of the Notice had personal employment histories that indicated that they posed no more risk to the public than the AP population at large. The Board recognized that employers may be wary of hiring such

individuals despite years of Associate membership without disciplinary problems. This is particularly true with small firms, where hiring one of these individuals might trigger the enhanced supervisory procedures and require the firm to apply for a waiver. In addition, some firms are simply loath to hire any individual who would be counted as having come from a Disciplined Firm, even if doing so would not trigger the enhanced supervisory procedures.

Currently, the Notice provides for two types of exemptions, which focus on an AP's length of employment at a Disciplined Firm (*i.e.*, less than sixty days) and the time since an AP has been employed at a Disciplined Firm (*i.e.*, more than ten years). The Board decided to grant relief to these defined groups because staff's analysis showed that given their background they pose minimal risk. With regard to the second type of exemption, the Notice currently provides that APs are exempt from being counted as having worked at a Disciplined Firm if: (1) They worked at only one Disciplined Firm; (2) that employment terminated more than ten years ago; (3) they have not personally been subject to a disciplinary action by NFA or the CFTC; (4) they have been registered as APs and Associate Members of NFA for eight of the last ten years; and (5) since working for the Disciplined Firm they have not worked for any other firm that has been subject to a sales practice action.

In practice, this latter condition acts as a *de facto* perpetual bar to receiving the exemption even if the AP's employment at the second firm subject to a sales practice action also occurred many years in the past.

The NFA performed an analysis of the effect of applying a ten-year time limit not only to the length of time since an AP was employed at a Disciplined Firm but also to the condition that the AP not work at a firm that had a sales practice action since being employed at the Disciplined Firm. This analysis showed that the current exemption could prudently be revised to include APs who met the other existing criteria, and who had worked more than ten years ago at a firm that was subject to a sales practice action. This change would afford this exemption to approximately 85 additional individuals who, based upon their employment histories, do not appear to pose any greater risk of using fraudulent sales tactics than the general population of APs.<sup>7</sup>

<sup>7</sup> There are more than 13,000 individuals who have ever worked as an AP at a Disciplined Firm. Approximately 2,100 of those individuals are

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

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

<sup>3</sup> NFA filed a letter from the CFTC notifying the NFA that it had determined not to review the proposed rule change. See note 4.

<sup>4</sup> See letter from William Penner, Deputy Director, CFTC, to Thomas W. Sexton, III, Esq., General Counsel, NFA, dated September 18, 2008.

<sup>5</sup> 15 U.S.C. 78o-3(k).

<sup>6</sup> 15 U.S.C. 78o(b)(11).

Excluding these APs from the calculation that triggers a firm's obligation to comply with the enhanced supervisory procedures is consistent with the reasoning behind the existing exemptions. Ultimately, the proposed expanded exemption would have the effect of removing some non-problematic individuals and Member firms from the waiver process.

The Notice also provides that one of the enhanced supervisory requirements is an increased adjusted net capital ("ANC") level. The Notice currently provides that FDMs that are required to undertake the enhanced supervisory requirements are obligated to maintain ANC of at least \$2,000,000. When the Board adopted that provision, FDMs that were not subject to the enhanced supervisory requirements had a minimum ANC of \$1,000,000. However, revisions to NFA Financial Requirements Section 11 in December 2007 raised the required minimum level of ANC for all FDMs to \$5,000,000, thus rendering the \$2,000,000 requirement irrelevant. Furthermore, the CFTC Reauthorization Act of 2008 further increases the ANC for FDMs, phasing in the increase to an eventual \$20 million.

The proposed revisions to the enhanced supervisory requirements would reinstate an increased ANC level for FDMs and make the provision more flexible in addressing future changes. These revisions tie the enhanced ANC level for FDMs to the early warning requirement under CFTC rules, which is currently 150 percent of the required ANC.

Under the proposal (and assuming the CFTC's early warning percentage remains unchanged), a triggering FDM would currently have to maintain an enhanced ANC of \$7,500,000, increasing to \$30,000,000 as the minimum ANC for FDMs increases from \$5,000,000 to \$20,000,000 over the next year. This revision would not only have the effect of bringing the current enhanced ANC obligation into harmony with the revisions made to NFA Financial Requirements Section 11 in December 2007, it would also keep the obligation in harmony with any future changes to the level of ANC required of FDMs without requiring further amendments to the Notice.

Amendments to the Notice were previously filed in SR-NFA-2001-01, SR-NFA-2002-07, SR-NFA-2003-01, SR-NFA-2005-01, SR-NFA-2006-01,

exempted from having to be included in a firm's calculation of whether it has triggered enhanced supervision under the current exemptions provided for in the Notice.

SR-NFA-2007-03, and SR-NFA-2007-07.

## 2. Statutory Basis

The rule change is authorized by, and consistent with, Section 15A(k)(2)(B) of the Act.<sup>8</sup> That Section requires NFA to have rules that are designed to prevent fraudulent and manipulative acts and practices, to promote just and equitable principles of trade, and, in general, to protect investors and the public interest, including rules governing sales practices and advertising of security futures products. The proposed rule change accomplishes this by imposing enhanced supervisory requirements on firms at risk for sales practice fraud, and the proposed rule change makes technical amendments to conform the Notice to NFA's experience with the rule and to upcoming changes to the capital requirements.

This proposed rule change is not designed to regulate, by virtue of any authority conferred by the Act, matters not related to the purposes of the Act or the administration of the association. To the extent that this proposal regulates activities and transactions other than security futures, the authority for regulating those activities and transactions comes from the Commodity Exchange Act rather than the securities laws.

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

The changes to the events that trigger application of the rule will lessen the burden on competition by exempting additional firms and individuals from the enhanced supervision requirements, which are imposed on NFA Member firms that hire a significant amount of their sales force from firms that have been barred from the industry for sales practice fraud. This part of the rule change should decrease the number of firms who are subject to the requirements.

The changes to the capital requirement will impose additional burdens on firms subject to the rule. However, the primary impetus for this change is Congressional legislation raising the capital requirement for firms that act as counterparties to retail off-exchange foreign currency transactions to an amount far in excess of the requirement currently set by the rule. While a small number of those firms may be registered as brokers or dealers under Section 15(b)(11) of the Act, the capital requirement is based on activities unrelated to that registration. Furthermore, the Board has considered

the burden on competition and has determined a larger capital requirement is necessary and appropriate to protect customers from unethical practices by firms subject to the rule.

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

NFA did not publish the rule changes to the membership for comment. NFA did not receive comment letters concerning the rule changes.

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

On September 18, 2008, the CFTC notified the NFA that it had determined not to review the proposed rule change and, therefore, NFA was permitted to make the amendments effective as of this date.<sup>9</sup> At any time 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 Act.

## 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. Comments may be submitted by any of the following methods:

### Electronic Comments

- Use the Commission's Internet comment form (<http://www.sec.gov/rules/sro.shtml>); or
- Send an e-mail to [rule-comments@sec.gov](mailto:rule-comments@sec.gov). Please include File Number SR-NFA-2008-02 on the subject line.

### Paper Comments

- Send paper copies in triplicate to Secretary, Securities and Exchange Commission, 100 F Street, NE., Washington, DC 20549-1090.

All submissions should refer to File Number SR-NFA-2008-02. This file number should be included on the subject line if e-mail is used. To help the Commission process and review your comments more efficiently, please use only one method. The Commission will post all comments on the Commission's Internet Web site (<http://www.sec.gov/rules/sro.shtml>). Copies of the submission, all subsequent

<sup>8</sup> 15 U.S.C. 78o-3(k)(2)(B).

<sup>9</sup> See note 4.

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 Section, 100 F Street, NE., Washington, DC 20549, on official business days between the hours of 10 am and 3 pm. Copies of such filing also will be available for inspection and copying at the principal office of the NFA. All comments received will be posted without change; the Commission does not edit personal identifying information from submissions. You should submit only information that you wish to make available publicly. All submissions should refer to File Number SR-NFA-2008-02 and should be submitted on or before October 29, 2008.

For the Commission, by the Division of Trading and Markets, pursuant to delegated authority.<sup>10</sup>

**Florence E. Harmon,**

*Acting Secretary.*

[FR Doc. E8-23840 Filed 10-7-08; 8:45 am]

**BILLING CODE 8011-01-P**

## SECURITIES AND EXCHANGE COMMISSION

[Release No. 34-58694; File No. SR-NSCC-2008-07]

### Self-Regulatory Organizations; National Securities Clearing Corporation; Order Approving Proposed Rule Change To Enhance Processing of Exchange-Traded Funds

September 30, 2008.

#### I. Introduction

On July 22, 2008, the National Securities Clearing Corporation ("NSCC") filed with the Securities and Exchange Commission ("Commission"), proposed rule change SR-NSCC-2008-07 pursuant to Section 19(b)(1) of the Securities Exchange Act of 1934 ("Act").<sup>1</sup> The proposed rule change was published for comment in the **Federal Register** on August 12, 2008.<sup>2</sup> No comment letters were received on the

proposal. This order approves the proposal.

#### II. Description

The proposed rule change expands processing of shares in exchange-traded funds ("Index Receipts") to allow for cash as a sole component of creations and redemptions and provides for an optional shortened processing cycle for creates and redeems of Index Receipts and their underlying components.

##### A. Current Process

Currently, on the day before trade date ("T-1"), an Index Receipt agent transmits files to NSCC that contain information regarding the underlying composition of Index Receipts for creates and redeems occurring the next business day.<sup>3</sup> NSCC compiles the information that evening and provides members with a portfolio composition report listing the composition of Index Receipts eligible for processing. The report displays the proportionate amount of underlying stocks that compose each Index Receipt and contains a cash component, which is an estimation of accrued dividends and any necessary balancing amount.<sup>4</sup> The portfolio information contained in this report is used for creation and redemption processing the next day, which is the Trade Date. On Trade Date, by such time as established by NSCC, the Index Receipt agent, acting on behalf of each member placing an Index Receipt order, will report to NSCC the number of Index Receipts created and redeemed that day. Transactions listed on the report are locked-in transactions between the Index Receipt agent and the member. The Index Receipt agent also will report the final cash amount and a transaction amount that represents the Index Receipt agent's transaction fee. On the night of Trade Date, NSCC transmits an Index Receipt instruction detail report to members that had activity on Trade Date. The report serves as the contract for the creation and redemption activity and lists the number of component shares that the member, depending upon the underlying shares' CNS eligibility, will deliver to or receive on settlement date ("T+3") from CNS or as an item allotted through the Balance Order Accounting Operation. On the night of Trade Date,

<sup>3</sup> NSCC's current processing functions are set forth in Procedure II, Section H of NSCC's Rules.

<sup>4</sup> The balancing amount is designed to compensate for any difference between the net asset value of the Index Receipt and the value of the underlying index. Among other reasons, a difference in value could result from the fact that an Index Receipt cannot contain fractional shares of a security.

each Index Receipt instruction is separated into its underlying stock components, and these components are processed through CNS or the Balance Order Accounting Operation and are incorporated into the normal equity clearance and settlement process. Unsettled positions in Index Receipts and their component securities are currently risk managed as ordinary activity and are guaranteed pursuant to the provisions of Addendum K of NSCC's rules.

##### B. Enhancements

For the past two years, demand for NSCC's create and redeem service has increased significantly each year with activity for Index Receipts with non-U.S. equity components increasing the most. As more fully described below, the proposed enhancements will allow members to create Index Receipts that (i) have underlying securities other than domestic equity securities for cash as consideration and (ii) will allow an optional shortened settlement cycle for creates and redeems and their underlying components.

##### 1. Expand the Index Receipt Process to Allow for Cash as Sole Component for Creations and Redemptions

Currently all component securities must be CNS eligible to qualify for NSCC's Index Receipt processing. Cash is used as a component only for accrued dividends and any balancing amount but is not used as a separate underlying component.

NSCC is expanding its Index Receipt processing to allow for creates and redeems using cash as the sole underlying component. This enhancement will allow members and their agent banks to create and redeem Index Receipts whose underlying components are not currently eligible for processing at NSCC (for example, commodity Index Receipts). The Index Receipt agent would use the cash to purchase the components, the settlement of which would occur outside of NSCC.

##### 2. T+1 and T+2 Settlement of Creations and Redemptions

NSCC currently supports the creation and redemption of Index Receipts with underlying components scheduled to settle on a T+3 basis. NSCC is expanding its Index Receipt processing to allow a member to create and redeem Index Receipts with a shortened settlement cycle. Currently, shortened settlement for standard equity CNS trades (e.g., next day settlement) is reported in the Consolidated Trade Summary and guaranteed on the night

<sup>10</sup> 17 CFR 200.30-3(a)(73).

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

<sup>2</sup> Securities Exchange Act Release No. 58314 (Aug. 5, 2008), 73 FR 46958 (Aug. 12, 2008) [File No. SR-NSCC-2008-07].