

## SECURITIES AND EXCHANGE COMMISSION

[Release No. 34-63602; File No. SR-NFA-2010-04]

### Self-Regulatory Organizations; National Futures Association; Notice of Filing and Immediate Effectiveness of Proposed Amendments, as Modified by Amendment No. 1 Thereto, to the Interpretive Notice Regarding NFA Compliance Rule 2-9: Enhanced Supervisory Requirements

December 22, 2010.

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 October 7, 2010, 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 substantially prepared by the NFA. On December 7, 2010, NFA filed Amendment No. 1 to the proposed rule change. 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 with the Commodity Futures Trading Commission ("CFTC").

On October 6, 2010, NFA requested that the CFTC make a determination that review of the proposed rule change of NFA is not necessary.<sup>3</sup> On October 20, 2010, the CFTC notified NFA that it had 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 proposed amendments to NFA Compliance Rule 2-9's Interpretive Notice entitled "Enhanced Supervisory Requirements" ("Notice") would provide limited relief for some Members that currently would qualify for the enhanced supervisory requirements ("Requirements") based on a firm principal's previous affiliation with another Member firm that was subject to the Requirements; makes changes to the enhanced capital requirements in light of a recent increase in the futures commission merchant ("FCM") minimum capital requirement; makes

changes to deal with the enhanced capital requirements for commodity pool operators ("CPOs") and commodity trading advisors ("CTAs") in a manner more consistent with the nature of their business; requires specific items to be included in a firm's written supervisory procedures; requires quarterly rather than monthly reports on a firm's compliance with the Requirements; and includes clarifying language in three areas: (1) Charging abnormally high commissions and fees; (2) the effect that receiving a waiver has on determining whether a Member is a firm that has met the criteria for future situations involving the Requirements; and (3) the status of a "five year" Disciplined Firm after it has been dropped from the "five year" list.

The text of the Interpretive Notice is available on NFA's Web site at <http://www.nfa.futures.org>, the Commission's Web site at <http://www.sec.gov>, the self-regulatory organization's office, and at the Commission's Public Reference Room.

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

In its filing with the Commission, NFA 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. NFA 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

Section 15A(k) of the Exchange 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 Exchange Act.<sup>6</sup> The Interpretive Notice entitled: "NFA Compliance Rule 2-9: Enhanced Supervisory Requirements" applies to all Members, including those who are registered as security futures brokers or dealers under Section 15(b)(11) of the Exchange Act.

Member firms trigger the Requirements based upon the regulatory background of either their associated

persons ("APs") or principals. Member firms triggering the Requirements must record all telephone conversations with customers and prospects, pre-submit promotional material, adopt written supervisory procedures and either operate under a guarantee agreement or maintain an enhanced capital level. The proposed amendments to the Notice include:

- Limited relief for some Members that would currently qualify for the Requirements based on a firm principal's previous affiliation with another Member firm that was subject to the Requirements;
- Changes to the enhanced capital requirements in light of a recent increase in the FCM minimum capital requirement;
- Changes to deal with the enhanced capital requirements for CPOs and CTAs in a manner more consistent with the nature of their business;
- Requiring specific items to be included in a firm's written supervisory procedures;
- Requiring quarterly rather than monthly reports on a firm's compliance with the Requirements; and
- Clarifying language regarding: (1) Charging abnormally high commissions and fees; (2) the effect that receiving a waiver has on future situations involving the Requirements; and (3) the status of a "five year" Disciplined Firm after it has been dropped from the "five year" list.

Historically, a Member would trigger the Requirements only if it had a defined percentage of APs who had previously worked for a Disciplined Firm.

In 2005, NFA's Board made revisions to the Notice after recognizing that the principals of several firms that had triggered the Requirements had avoided them by simply closing their firms and opening other firms that had a mix of APs that did not trigger the Requirements. NFA noted that the new firms typically had APs from the closed firm who had worked at Disciplined Firms, but their percentage ratios to the overall AP population of the new firms were below the triggering point for imposing the Requirements. NFA's Board addressed this issue by amending the Notice to provide that once a firm had triggered the Requirements, then any other firms of which the principals of the qualifying firm are also principals would become subject to the Requirements.

NFA believes that the 2005 revision has been generally effective in discouraging the practice of sham reorganizations to avoid the Requirements. However, NFA has found

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

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

<sup>3</sup> See Letter from Thomas W. Sexton III, Senior Vice President/General Counsel, NFA, to William Penner, Deputy Director, CFTC (Oct. 6, 2010).

<sup>4</sup> See Letter from William Penner, Deputy Director, CFTC, to Thomas W. Sexton III, General Counsel, NFA (Oct. 20, 2010).

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

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

that there were some principals whose firms triggered the Requirements with backgrounds that suggested they were not part of the population to which the amendment was designed to apply. NFA undertook the task of identifying objective criteria that were met by individuals who did not appear to be part of the target group but were, nevertheless, affected by the 2005 amendment. In doing so, NFA focused on criteria similar to those that have been adopted to provide exemptions to some APs who previously worked at Disciplined Firms. These criteria include a clean personal regulatory record and limited affiliation with potentially problematic Members.

NFA has identified a set of five criteria that apply to approximately 60 individuals and approximately five entities that do not appear to raise undue concerns regarding their ability to effectively supervise their firms. Those criteria include the following:

- The principal has not been personally subject to a disciplinary action by NFA or the CFTC;
- The principal has been a principal of only one firm that has qualified for the Requirements;
- The principal has never been a principal or an AP of a current Disciplined Firm;
- The firm in the principal's history that triggered the Requirements either received a full waiver from the Requirements or abided by the Requirements for at least two years and is no longer subject to the Requirements; and
- The firm in the principal's history that triggered the Requirements has not become subject to a sales practice action since triggering the Requirements.

NFA believes that exempting Members from adopting the Requirements when those Requirements are triggered by a principal who meets the aforementioned five criteria would eliminate the need for some waiver petitions (which are typically granted), saving time and undue complications for the affected Members, the Telemarketing Procedures Waiver Committee ("Waiver Committee") and NFA staff. NFA believes that this exemption could provide relief to certain principals whose profiles indicate that they are unlikely to pose any supervisory issues. In addition, NFA does not believe that this change will diminish customer protection because the principals that will be exempted are those principals who would almost always have been granted a waiver based on meeting the aforementioned criteria.

The Notice currently provides that FCMs affected by the Notice are required to maintain adjusted net capital ("ANC") of at least \$1,000,000. When this provision was adopted the minimum ANC level was \$500,000. However, the minimum ANC for all FCMs was raised to \$1,000,000 in March 2010, rendering the current provision moot.

NFA proposes to revise the language in the Notice regarding the enhanced level of ANC required to be maintained by affected FCMs to tie the required enhanced ANC to the minimum ANC for FCMs. The proposed amendments would track the approach taken by the Board in 2008 to deal with changes to the enhanced ANC provision for Forex Dealer Members ("FDMs"). Specifically, rather than set a defined number, it would tie the enhanced ANC level for FCMs to the early warning requirement under CFTC rules, which is currently 150% of required ANC. NFA believes that this revision would not only bring the current enhanced ANC obligation into harmony with that required of FDMs, but would also provide flexibility in light of any future changes to the level of the minimum ANC required of FCMs.

The Notice currently requires CPOs and CTAs that trigger the Requirements to maintain ANC of at least \$250,000. In addition, affected CPOs and CTAs are currently subject to the financial recordkeeping and reporting requirements applicable to FCMs.

According to NFA, it is relatively uncommon for CPOs and CTAs to qualify for the Requirements, and if CPOs and CTAs do qualify, they often request relief from the \$250,000 capital requirement even if they are required to tape. The Waiver Committee has dealt with ten waiver petitions from CPO or CTA Members and completely denied five of those petitions. Four of those firms are no longer NFA Members. The other five received partial waivers that reduced the enhanced ANC requirement. Two waivers set the required ANC level at \$100,000, two set it at \$75,000, and one eliminated the obligation altogether. Three of the five firms that received waivers remain NFA Members. In granting these petitions, the Waiver Committee recognized that because CPOs and CTAs do not have a minimum net capital requirement, imposing the reduced \$100,000 requirement was sufficient to meet the purpose of the requirement.

In light of the Waiver Committee's past decisions regarding this issue, NFA proposes to amend the Notice to reduce the ANC required of CPOs and CTAs that trigger the Requirements from the

current \$250,000 to \$100,000. In addition, the proposed amendments to the Notice would provide that the financial recordkeeping and reporting obligations of affected CPOs and CTAs be simplified by merely requiring them to demonstrate compliance with their enhanced ANC obligation to NFA upon request.

The proposed amendments to the Notice identify specific areas that would need to be addressed by an affected Member in the written supervisory procedures they are required to prepare. NFA believes that this addition will give clear guidance as to the minimum standards to be met in preparing written supervisory procedures. Generally, the proposed language requires procedures for monitoring, cataloging and logging taped conversations in an affected Member's written supervisory procedures.

The Notice currently requires affected Members to file monthly reports regarding their compliance with the Requirements. It has been NFA's experience in reviewing these reports that most of them tend to be repetitious in nature. Nevertheless, NFA feels that the reports are useful in that they periodically bring the Member's focus to bear on the Requirements, create a written historical record and, on occasion, may provide the impetus for corrective action by the Member. NFA proposes to change the frequency of the obligation to file such reports from monthly to quarterly. NFA believes that lengthening the frequency for filing the reports will not in any way diminish customer protection because the reports alone do not typically form the basis of an NFA investigation or disciplinary action. Moreover, NFA uses other methods to monitor Member compliance with the Requirements.

Members that charge 50% or more of their active customers round-turn commissions, fees and other charges that total \$100 or more per futures, forex or option contract are required to adopt the Requirements. NFA represents that it has recently encountered situations in which Members purchase out-of-the-money options and charge a commission just short of \$100. In these situations there are additional charges if the option is liquidated that would bring total charges above \$100; however, NFA believes that it is often the case that the out-of-the-money options expire worthless and no additional costs are assessed. The result is that some Members are able to avoid the Requirements by encouraging their customers to take on riskier out-of-the-money positions that are less likely to

incur liquidation charges that would raise costs to \$100 or more.

Members that engage in the practice described above are, in NFA's view, clearly within the group of Members that the Board believed should be subject to the Requirements when it chose to use high commissions and fees as a trigger for imposing the Requirements. Therefore, the proposed amendments to the Notice provide that trading an options contract that would result in total commissions, fees and other charges of \$100 or more if the trade was liquidated will be deemed to have been charged \$100 even if the contract is not ultimately liquidated.

The proposed amendments to the Notice would add language that NFA believes would clarify that a Member that receives a full or partial waiver is still deemed to be a Member that has met the criteria for purposes of the Notice.

From 1993 until 2007, the term "Disciplined Firm" included only Members that had been permanently barred from the industry as the result of a sales practice or promotional material action. In 2007, the amendments to the Notice added Members that had been sanctioned in any way in a sales practice or promotional material action within the preceding five years to the definition of a Disciplined Firm. This resulted in the creation of a list of "five year" Disciplined Firms that is separate from the list of permanent Disciplined Firms. The electronic reporting system that monitors Disciplined Firms automatically removes these firms from the Disciplined Firm list once five years have passed.

According to NFA, there has been some confusion expressed as to whether a "five year" Disciplined Firm is still considered to be a Disciplined Firm for purposes of triggering the Requirements once the firm is dropped from the "five year" list. NFA believes that the proposed amendments to the Notice would eliminate this confusion by simply adding the word "current" before the term "Disciplined Firm" in four relevant places in Section III (B)(1) of the Notice.

Amendments to the Interpretive Notice regarding NFA Compliance Rule 2-9: Enhanced Supervisory Requirements were previously filed with the SEC in SR-NFA-2003-01, Exchange Act Release No. 34-47533 (Mar. 19, 2003), 68 FR 14733 (Mar. 26, 2003); SR-NFA-2005-01, Exchange Act Release No. 34-52808 (Nov. 18, 2005), 70 FR 71347 (Nov. 28, 2005); SR-NFA-2006-01, Exchange Act Release No. 34-53568 (Mar. 29, 2006), 71 FR 16850 (Apr. 4, 2006); SR-NFA-2007-03,

Exchange Act Release No. 34-55710 (May 4, 2007), 72 FR 26858 (May 11, 2007); SR-NFA-2007-07, Exchange Act Release No. 34-57142 (Jan. 14, 2008), 73 FR 3502 (Jan. 18, 2008); and SR-NFA-2008-01, Exchange Act Release No. 34-57640 (Apr. 9, 2008), 73 FR 20341 (Apr. 15, 2008).

## 2. Statutory Basis

NFA believes that the proposed rule change is authorized by, and consistent with, Section 15A(k)(2)(B) of the Exchange Act.<sup>7</sup> That section sets out requirements for rules of futures associations, registered under Section 17 of the Commodity Exchange Act,<sup>8</sup> that are a registered national securities association for the limited purpose of regulating the activities of members who are registered as brokers or dealers in security futures products pursuant to Section 15(b)(11) of the Exchange Act. Under Section 15A(k)(2)(B), the rules of such a limited purpose national securities association must be 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 the advertising of security futures products reasonably comparable to the rules of a registered national securities association applicable to security futures products. NFA believes the proposed rule change would meet these requirements by: Providing limited relief for some Members that would currently qualify for the Requirements based on a principal's previous affiliation with another Member firm that was subject to the Requirements; changing the enhanced capital requirements in light of a recent increase in the FCM minimum capital requirement; changing the enhanced capital requirements for CPOs and CTAs in a manner more consistent with the nature of their business; requiring specific items to be included in a firm's written supervisory procedures; requiring quarterly rather than monthly reports on a firm's compliance with the Requirements; and clarifying language regarding—charging abnormally high commissions and fees; the effect that receiving a waiver has on determining whether a Member is a firm that has met the criteria for futures situation involving the Requirements; and the status of a "five year" Disciplined Firm after it has been dropped from the "five year" list.

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

NFA believes that the portion of the proposed rule change that exempts Members from adopting the Requirements when those Requirements are triggered by a principal who meets the specified five criteria should lessen the burden on competition by eliminating the need for waiver requests that are typically granted and decreasing the number of firms that are subject to the requirement by automatically exempting firms that qualify based on principals whose profiles indicate that they are unlikely to pose supervisory problems.

NFA does not believe that the proposed changes to CPO and CTA capital requirements and reporting requirements for firms that trigger the Requirements would impose any burden on competition.

Although the proposed rule change would require FCMs subject to the Requirements to maintain additional capital, NFA believes that the increase is necessary in order to maintain the purpose behind the Requirements, and is also consistent with the approach NFA adopted with respect to FDMs. The minimum capital level for all FCMs was recently increased to \$1,000,000, which is the same amount currently required of FCMs subject to the enhanced requirement. In order for the enhanced Requirements to maintain their original purpose, NFA believes that the capital requirement must be increased. Rather than setting another fixed dollar amount, the proposed amendment would tie the required enhanced ANC to the early warning requirement under CFTC rules (150% of minimum ANC). This revision would impose the same standard on FCM and FDM Members and take into consideration any future changes to ANC levels.

The proposed rule change identifies specific areas that need to be addressed by an affected Member in the written supervisory procedures it is currently required to prepare. NFA represents that the changes would not impose additional substantive requirements on Members. Rather, NFA believes this language would address requests for Members for specific guidance on how to comply with their obligation to monitor, catalog and log taped conversations. Therefore, NFA does not believe this change imposes any burden on competition.

The current rule requires Members that charge 50% or more of their active customers round-turn commissions, fees and other charges that total \$100 or more per futures, forex or option

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

<sup>8</sup> 7 U.S.C. 21.

contract to adopt the Requirements. NFA has identified a trend where some Members encourage their customers to take on riskier out-of-the-money options at a cost just below \$100. Because in NFA's view these positions are much less likely to be liquidated and charged a liquidation fee, the total cost remains under the \$100 threshold. NFA states that the proposed rule change may increase the number of Members subject to the Requirements because option contracts that would result in total commission, fees and other charges of \$100 or more if the trade was liquidated will be deemed to have been charged \$100 even if the trade is not liquidated. NFA believes that the additional burden is necessary, however, because Members that engage in this practice are clearly within the group of Members that NFA's Board believed should be subject to the enhanced Requirements when it chose to use high commissions and fees as a trigger for imposing the Requirements.

NFA believes that the proposed provision that changes a Member's reporting obligation with respect to its report on compliance with the Requirements will also lessen the burden on Members. Under this provision, a Member will be permitted to file this report on a quarterly rather than monthly basis.

NFA believes that the final two proposed revisions do not add any burden to competition because they are merely clarifying current requirements. One proposed rule change would add language that NFA believes makes it clear that a Member that receives a full or partial waiver is still deemed to be a Member that has met the criteria for purposes of the Notice. Another proposed rule change would add the word "current" before the term "Disciplined Firm" in four relevant places in order to clarify that a "five year" Disciplined Firm will no longer be a Disciplined Firm for purposes of triggering the Requirements once the firm is dropped from the "five year" list.

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

NFA states that it worked with its Member Advisory Committees in developing the rule change. NFA did not, however, publish the rule change to its membership for comment. NFA states that it did not receive comment letters concerning the rule change.

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

On October 20, 2010, the CFTC notified NFA that it had approved the rule change, and therefore, NFA is permitted to make the amendments effective as of this date.

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 is consistent 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-2010-04.

#### *Paper Comments*

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

All submissions should refer to File Number SR-NFA-2010-04. 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 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 Web site viewing and printing in the Commission's Public Reference Room, 100 F Street, NE., Washington, DC 20549, on official business days between the hours of 10 a.m. and 3 p.m. Copies of such filing

also will be available for inspection and copying at the principal office of 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 publicly available.

For the Commission, by the Division of Trading and Markets, pursuant to delegated authority.<sup>9</sup>

**Florence E. Harmon,**

*Deputy Secretary.*

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**BILLING CODE 8011-01-P**

## **SOCIAL SECURITY ADMINISTRATION**

### **Agency Information Collection Activities: Proposed Request**

The Social Security Administration (SSA) publishes a list of information collection packages requiring clearance by the Office of Management and Budget (OMB) in compliance with Public Law 104-13, the Paperwork Reduction Act of 1995, effective October 1, 1995. This notice includes revisions to OMB-approved information collections.

SSA is soliciting comments on the accuracy of the agency's burden estimate; the need for the information; its practical utility; ways to enhance its quality, utility, and clarity; and ways to minimize burden on respondents, including the use of automated collection techniques or other forms of information technology. Mail, e-mail, or fax your comments and recommendations on the information collection(s) to the OMB Desk Officer and SSA Reports Clearance Officer at the following addresses or fax numbers.

(OMB), Office of Management and Budget, *Attn:* Desk Officer for SSA. *Fax:* 202-395-6974. *E-mail address:* [OIRA\\_Submission@omb.eop.gov](mailto:OIRA_Submission@omb.eop.gov).

(SSA), Social Security Administration, DCBFM, *Attn:* Reports Clearance Officer, 1333 Annex Building, 6401 Security Blvd., Baltimore, MD 21235. *Fax:* 410-965-6400. *E-mail address:* [OPLM.RCO@ssa.gov](mailto:OPLM.RCO@ssa.gov).

The information collections below are pending at SSA. SSA will submit them to OMB within 60 days from the date of this notice. To be sure we consider your comments, we must receive them no later than March 4, 2011. Individuals can obtain copies of the collection instruments by calling the SSA Reports Clearance Officer at 410-965-8783 or by writing to the above e-mail address.

<sup>9</sup> 17 CFR 200.30-3(a)(73).