



# Security Futures Products

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## A Regulatory Guide

January 2004

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The Commodity Futures Modernization Act of 2000 (CFMA) authorized futures contracts on single securities and narrow-based indices (security futures products). Unlike other futures contracts, however, the CFMA provides that security futures products are both futures and securities and are regulated under both schemes.

When the President signed the CFMA on December 21, 2000, NFA became a national securities association for the limited purpose of regulating the activities of our Members who are notice-registered as brokers or dealers in security futures products. These firms are allowed to register by filing a short notice-form and are exempt from some provisions of the securities laws because they limit their securities activities to security futures products. Registration requirements are discussed in more detail in a later section.

This Guide is primarily for our Members who notice-register as broker-dealers. If your firm is a fully registered securities broker-dealer, you are required to meet NASD's security futures requirements. NFA's rules are very similar to NASD's rules, but there are a few differences.

Since the securities laws apply to security futures products, the regulatory scheme for these products introduces new requirements. We have developed this Guide to help our Members understand these requirements and provide you with resources about offering and trading security futures products for customers. However, this Guide does not cover every requirement and does not include every detail about the requirements it does cover. You should read NFA's rules and interpretive notices and the CFTC and SEC rules for intermediaries engaged in security futures activities. The most significant rules are listed in Appendix 1 at the back of this Guide.

The CFMA required NFA to adopt several additional requirements for security futures products. As you will see when you read this Guide, we adopted a new Compliance Rule 2-37, enhanced our existing rules, and adopted several new interpretive notices. We have listed the relevant rules and interpretive notices at the end of each section. You can refer to these for clarification and specific details about each requirement. NFA's other futures rules also apply to these products.

We hope you will find this Guide useful, and we welcome your suggestions on how we can better assist you in meeting your regulatory obligations.

## What are Security Futures?

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Security futures products are futures whose underlying instrument is either a single security or a narrow-based security index.

Security futures do not include futures on broad-based stock indices, such as the Dow Jones Industrial Average, the Nasdaq indices, the NYSE Composite, and the S&P 500 that currently trade on futures exchanges. These indices are regulated by only the CFTC and must be traded through a futures firm.

Security futures products do not represent ownership in a corporation and, therefore, the owner of the security futures contract is not regarded as a stockholder and does not receive dividends or invitations to stockholder's meetings.

Security futures may be traded on a variety of facilities, including registered securities and futures exchanges and alternative trading systems. Like other futures contracts, security futures are currently not fungible (i.e., you must liquidate a specific security futures contract on the same exchange where you purchased it).

### Futures on Single Securities

Futures on single securities can involve a single stock, an exchange-traded fund, or another type of security jointly authorized by the CFTC and the SEC. For example, if a customer purchases a December 2003 contract on XYZ stock at the current futures price, the customer has entered into a legally binding agreement to buy XYZ stock in December 2003.

### Futures on Narrow-Based Security Indices

In this case, a customer purchases a futures contract for a stock index that represents only a small part of the market. The indices may include stocks from particular industries such as telecommunications or airlines. This allows customers to trade in a specific market sector. For example, if a customer purchases a December 2003 contract on the ABC index, the customer has entered into an agreement to buy the underlying stocks in December 2003 in the proportions included in the index.

An index is considered a narrow-based security index if it has any one of the following characteristics:

- The index consists of nine or fewer component securities;
- One stock constitutes more than 30 % of the index's weighting;
- The five highest weighted stocks comprise more than 60 percent of the index's weighting; or
- Securities in the lowest 25 % of the index's weighting fall below specified thresholds of average daily trading volume.

### Additional Resources

For more detailed information about the specific security futures products that are currently traded, we recommend that you consult the various exchanges that offer these products. We have included a list of these exchanges in Appendix 2 of this Guide.

## Registration and Proficiency Requirements

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Because security futures products are securities as well as futures, the CFMA gave the CFTC and the SEC joint jurisdiction over them. As a result, brokerage firms must be registered with both agencies in order to offer and trade these products.

### FCMs and IBs

If your firm is a registered FCM or IB that is also fully registered with the SEC as a broker-dealer, it has no further registration obligations.

If your firm is not currently registered as a broker-dealer, it must notice-register by filing a Broker-Dealer Notice Registration Form (Form BD-N) with NFA. You can download this four-page form directly from NFA's Web site ([www.nfa.futures.org](http://www.nfa.futures.org)). There is no filing fee and the firm's notice-registration is effective upon filing as long as the form is complete and the eligibility requirements are met.

If your firm notice-registers as a broker-dealer, it will be exempt from some requirements of the securities laws that duplicate futures requirements. These include financial requirements, prohibitions on certain exchange members doing both proprietary and customer trading, and risk assessment rules. Also, your firm is not required to become a member of NASD since the firm's securities business must be limited to offering and trading security futures products.

Similarly, broker-dealers who are not currently FCMs or IBs can notice-register as FCMs or IBs if they are registered with the SEC as full-fledged broker-dealers and members of NASD. These firms notice-register with the CFTC on Notice Form 7-R, which is two pages long. Again, you can download the form from our Web site and file it with NFA. There is no fee, and registration is effective upon filing.

### CPOs

For CPOs and CTAs, SEC registration is not automatically required. If you are a CPO, you may be required to register a fund as an investment company and yourself as an investment adviser if the fund's security futures activities (combined with its other securities activities) bring it within the Investment Company Act's definition of investment company, although hedge fund exemptions apply. Persons operating hedge funds and investment companies must register as CPOs if they trade security futures and do not qualify for an exemption from CPO registration.

NFA Members need to check to see if the fund manager is either registered as a CPO and a Member of NFA or is exempt from registration before approving a fund account to trade security futures.

We have included some common questions and answers based on inquiries NFA has received from fund operators and advisors. Please see Appendix 3, Security Futures Issues for Fund Managers and Advisors, at the end of this Guide.

## CTAs

The CFMA provides exemptions for registered CTAs and SEC-registered investment advisers. If you are a registered CTA, you do not have to register as an investment adviser unless you primarily act as an investment adviser or you provide securities advice to registered investment companies or business development companies. Similarly, SEC-registered investment advisers do not have to register as CTAs unless they primarily act as CTAs or provide futures advice to funds whose primary activities are in exchange-traded futures.

NFA Members need to check to see if a third-party advisor is either registered as a CTA and a Member of NFA or exempt from CTA registration before accepting security futures trades from that advisor.

## Registration Requirements Summary

The following chart summarizes the various registration requirements discussed above:

<i>Current Registration</i>	<i>Additional Registrations</i>
FCM and BD	None
IB and BD	None
FCM	Notice BD
IB	Notice BD
BD	Notice FCM or IB
CPO	Possibly IA/IC
IC	Possibly CPO (for fund operator)
CTA	Possibly IA
IA	Possibly CTA

## Proficiency Requirements for NFA Registrants

Unlike brokerage firms, salespeople and supervisors do not have to be dually registered. However, NFA and NASD rules state that any registered securities or futures professional who intends to engage in a security futures business must complete a training program covering security futures. This applies to all sole proprietors and APs, including CPOs and CTAs and joint Series 3/ Series 7 registrants.

There are two ways to satisfy the training requirement. The first is through a Web-based training program that NFA developed in collaboration with NASD and The Institute for Financial Markets. The other option is to take another training program that covers the same basic content (see “Additional Resources” at the end of this section). In either case, individual registrants must complete the training prior to engaging in security futures activities.

What does the training consist of?

The training program has five modules:

- Stocks and Stock Options
- Futures Contracts
- Security Futures Products
- Regulatory Requirements for Security Futures
- Supervision of the Offer and Sale of Security Futures

Again, you may use the Web-based program offered free of charge by NFA and NASD or any other training program that covers the same basic content. A firm may allow its APs to opt out of certain parts of the training based on their previous testing and experience, and most APs will not have to take the supervision module.

A firm must ensure that all of its registered employees meet the proficiency requirements before engaging in security futures activities. NFA's Web-based training program provides a printable certificate when the training is completed. Also, NFA's on-line registration system notes whether an individual has completed his or her proficiency training so a sponsor can keep track of this information for all of its salespersons.

Designated Security Futures Principals

All FCMs and IBs who are notice-registered as broker-dealers must have one or more designated security futures principals (DSFPs) to oversee security futures activities at their firms. Branch office managers and current supervisors can qualify to become DSFPs through training. DSFPs will need to complete the supervision section of the security futures training program in addition to the other required sections.

Additional Resources

NFA Registration Rule 204

Interpretive Notice to NFA Compliance Rules 2-7 and 2-24 and Registration Rule 401: Proficiency Requirements for Security Futures Products

Content Outline for Security Futures Training (available on NFA's Web site)

As an NFA Member, you are already familiar with the requirement to know your customers and provide adequate risk disclosure. All of these requirements apply if you plan to offer security futures products to your customers. There are also some additional requirements for these products. First, you must provide a Risk Disclosure Statement for Security Futures Contracts to a customer prior to or when approving the account to trade security futures products. Second, you need to obtain additional information from customers to use in determining whether to approve an account to trade security futures. Finally, you must prepare and maintain a written approval or disapproval for each account. This section explains the steps you need to take to ensure that your account opening process meets these requirements.

### Risk Disclosure

NFA collaborated with NASD and other futures and securities SROs to develop a standardized risk disclosure statement for security futures. You need to provide the statement to your customers at or before the time the account is approved to trade security futures. Unless you are a member of NASD, you do not need to get a signed acknowledgement of receipt; however, you must maintain internal records documenting the date that you provided the statement to the customer.

The statement describes the general risks of security futures transactions. It also describes security futures and how they differ from the underlying securities and from options. Specific topics covered in the statement are the following:

- Risks of Security Futures
- Description of a Security Futures Contract
- Clearing Organizations and Mark-to-Market Requirements
- Margin and Leverage
- Settlement
- Customer Account Protections
- Special Risks for Day Traders
- Other
  - Corporate Events
  - Position Limits and Large Trader Reporting
  - Transactions on Foreign Exchanges
  - Tax Consequences
- Glossary of Terms

NFA has published the Risk Disclosure Statement for Security Futures Contracts, and you may order it from NFA for a nominal fee. You may also download the brochure from NFA's Web site. NFA does not require its Members to use the actual brochure or an exact copy of the document on NFA's Web site. You may make minor changes to the format for publishing purposes, such as changes to document margins or paper size. However, you cannot make formatting changes that alter the relationship between type sizes and fonts, change the prominence with which the disclosures are made or make the statement hard to read. Also, you cannot change the wording of the document in any way.

## Customer Account Information

Although you are already familiar with the requirements of NFA's "know your customer" rule, we have expanded our rule to include some additional information you need to obtain from your customers who wish to trade security futures.

Members must exercise due diligence to learn essential facts about each customer, including the customer's investment objectives and financial information, even if the customer is an institution. Unless the customer is an individual, however, Rule 2-30 does not specify the exact information you need to obtain.

The additional information that you will need to obtain from customers who are individuals includes the following:

- Whether the account will be for speculative or hedge trading;
- The customer's employment status (name of employer, self-employed, retired);
- The customer's estimated liquid net worth;
- The customer's marital status and number of dependents; and
- Any other information you may decide to use for making recommendations to your customers.

You can obtain this additional information through your account agreement, you can obtain it verbally, or you can use any other method that provides the information. For existing customers, you can also use an addendum to your account agreement. We have added a new requirement if the information is obtained verbally. In that case, you will need to verify the information in writing within 15 days after you have approved the account. Also, if you become aware of a material change in the customer account information for a customer who is an individual, you need to update the information and verify it in writing with the customer within 15 days of when you become aware of the change. If the customer does not notify you that the information is wrong, you can assume it is correct.

Our rule has always required that you document the customer information or, for U.S. customers, make a written record that the customer declined to provide it. For security futures, however, you must also make a written record when foreign customers refuse to provide the information.

See Appendix 4 for a list of the information you need to obtain from individual customers.

## Account Approval Process

Customers cannot trade security futures until a Member specifically approves the account to trade them. As noted above, Compliance Rule 2-30 requires a Member to exercise due diligence to learn essential facts about the customer, including the customer's investment objectives and financial situation. A DSFP needs to approve or disapprove the account to trade security futures based on those facts as well as other information gathered from the customer. These requirements apply to both individual and institutional customers.

If your firm is an FCM or IB, you will need to ensure that the following process is completed:

- A DSFP approves or disapproves the account in writing to trade security futures;
- A record is made showing who approved or disapproved the account; and
- The customer account records contain the following information:
  - The name of the associated person who opened the account;
  - How the customer's information was obtained (e.g., over the telephone, as part of the account agreement); and
  - The date the security futures disclosure statement was provided to the customer.

#### Suitability of Recommendations

NFA's Compliance Rule 2-30 is commonly referred to as our "know your customer" rule rather than a "suitability" rule. For security futures products, NFA expanded Rule 2-30 to incorporate suitability requirements. For non-discretionary accounts:

- you may not make a recommendation unless you have reasonable grounds for believing it is suitable for the customer based on the customer's current investment objectives, financial situation and needs, and any other information you are aware of;
- you may not make a recommendation unless you have a reasonable basis for believing the customer has knowledge and experience to be capable of evaluating the risks of the transaction and is financially able to bear the risk; and
- for non-institutional customers, you must also make a reasonable effort to obtain current information regarding the customer's financial status and investment objectives prior to recommending a transaction or strategy in security futures products. Obviously, you don't have to obtain this information before every recommendation if your recommendations occur within a relatively short time and you do not have any reason to believe that the information has changed.

A non-institutional customer is any customer except the following:

- A bank, savings and loan association, insurance company, registered investment company, registered commodity pool operator, or commodity pool operated by a registered commodity pool operator;
- An investment adviser registered either with the Securities and Exchange Commission under Section 203 of the Investment Advisers Act of 1940 or with a state securities commission (or any agency or office performing like functions) or a registered commodity trading advisor;
- An investment company exempt from registration under the Investment Company Act of 1940, a commodity pool operator exempt from registration under the Commodity Exchange Act, a commodity pool operated by

a commodity pool operator exempt from registration under the Commodity Exchange Act, an investment adviser exempt from both federal and state registration under the Investment Advisers Act of 1940, or a commodity trading advisor exempt from registration under the Commodity Exchange Act;

- A registered broker-dealer or futures commission merchant; and
- Any other entity (whether a natural person, corporation, partnership, trust, or otherwise) with total assets of at least \$50 million.

#### Discretionary Accounts

For discretionary accounts, you may not make trades that are excessive in size or frequency in view of the customer's investment objectives and financial situation.

#### Additional Resources

NFA Compliance Rule 2-30 – Customer Information and Risk Disclosure

Interpretive Notice to NFA Compliance Rule 2-30(b): Risk Disclosure Statement for Security Futures Contracts

NFA Compliance Rule 2-9 places a continuing responsibility on every Member to diligently supervise its employees in all aspects of its futures business. This rule applies to activities involving security futures products just as it does to all other futures-related activities.

A Member must develop and implement written supervisory procedures and appoint a designated security futures principal (DSFP) at each location that trades security futures products. The DSFP is responsible for enforcing your firm's procedures and recommending to senior management any action necessary to ensure compliance with the securities laws and NFA requirements. Every AP handling security futures trades must report to a specified DSFP.

Your firm's procedures must be reviewed by a DSFP and must be updated when necessary. Also, branch offices and guaranteed introducing brokers must keep a current copy of the procedures and receive updates in a timely manner.

We have prepared the following checklist that summarizes the firm's specific supervisory responsibilities for security futures. Obviously, these responsibilities can be split up and assigned to different personnel. Some of these responsibilities must be done by a DSFP, and the remaining responsibilities must be subject to a DSFP's oversight.

### Discretionary Accounts

- A DSFP must specifically approve the account to use discretion for security futures trades.
- A DSFP must regularly review discretionary security futures trading activity and make a written record of that review.

### Promotional Material and Correspondence

- A DSFP must review and approve in writing all security futures related promotional material (see the Promotional Material section of this Guide for a more detailed discussion of this requirement).
- Firm personnel must review incoming and outgoing correspondence with customers regarding security futures activity.
- The review of the correspondence must ensure that it is retained and that outgoing correspondence contains the names of the persons who prepared it.
- The firm must keep a record of who reviewed the correspondence and when it was reviewed. The specific review procedures will depend on the nature of the firm's business. For example, if your firm does business with only institutional or highly sophisticated customers, your firm might consider reviewing a sample of correspondence. On the other hand, if your firm deals with relatively unsophisticated retail customers, it should review a larger sample.
- The firm must train employees on its policies regarding correspondence with the public, with special attention given to those employees with previous compliance problems.

#### Account Approval

- A DSFP must approve or disapprove an account to trade security futures products before the first security futures trade in the account and must base the approval or disapproval on specific criteria adopted by the firm, including specific financial requirements.
- The DSPF must explain, in writing, why he or she approved an account that does not meet the firm's specific criteria and standards.
- The firm must adopt and enforce specific written procedures that cover the above.

#### Compliance with Securities Laws

- The firm must establish, maintain and enforce written procedures reasonably designed to ensure that the firm and its employees comply with applicable securities laws.
- A DSFP must approve these procedures in writing.

#### Use and Disclosure of the Member's Name

- The firm must establish supervisory procedures to reasonably ensure that the public knows who they are doing business with and that neither the firm nor its employees use misleading names, affiliations, or qualifications.

#### Supervision of Branch Offices and Guaranteed IBs

- Qualified personnel must conduct an annual, in-person, on-site review of each branch office and guaranteed IB that engages in security futures activities.

#### Hiring Employees and Entering into Guarantee Agreements

- The firm must establish procedures to screen prospective employees and guaranteed introducing brokers who will engage in security futures trading.
- Firm personnel must perform background checks through BASIC and the CRD system for any derogatory information on the firm's employees and the firm's guaranteed IBs, their principals and employees.
- The firm must obtain and review the employee's most recent Form 8-T or U-5 no later than 60 days after the individual files an application for AP registration.
- The DSFP must regularly review hiring practices to ensure qualified personnel are completing the screening procedures.

#### Meetings with Associated Persons

- Persons designated by the firm must conduct annual compliance meetings with all APs who trade security futures products. These meetings can be individual interviews or group meetings and may include other matters.

**Additional Resources**

**NFA Compliance Rule 2-7 – Branch Office Managers and Designated Security Futures Principals**

**NFA Compliance Rule 2-8 – Discretionary Accounts**

**NFA Compliance Rule 2-37 – Security Futures Products**

**Interpretive Notice to NFA Compliance Rule 2-9: Special Supervisory Requirements for Members Registered as Broker-Dealers Under Section 15(b)(11) of the Securities Exchange Act of 1934**

### General Information

NFA Compliance Rule 2-29 deals with the content of promotional material and other communications with the public. With the introduction of security futures products to the market, we have added some requirements specific to these products. While NFA's rules pertaining to security futures promotional material are more detailed than NFA's general promotional material rules, both sets of rules are designed to ensure that customers are not misled.

Before we start describing these new rules, it may be helpful to review some general definitions. First, what is promotional material? Promotional material can include all kinds of communications with the public but does not normally include routine day-to-day contact with customers. Promotional material includes:

- Standardized or scripted oral presentations;
- Newspaper or magazine articles;
- Scripted broadcasts;
- Standardized reports, letters, and e-mails;
- Publications; and
- Web sites.

What is security futures promotional material? It is material that specifically mentions security futures. Material that only includes references to security futures as one of the services offered by a member, however, is not security futures promotional material.

If your firm is an FCM or IB that is notice-registered as a broker-dealer, you will need to comply with the new section of our rule that specifically addresses security futures products, as well as the existing requirements outlined in Compliance Rule 2-29. Firms that are members of NASD will be required to follow NASD's rules.

NFA's rules differ depending on the type of security futures promotional material in use. Some requirements apply to all security futures promotional material, some apply only to material that reaches a targeted audience, and some apply only to mass media.

### General Requirements

The following requirements apply to all security futures promotional material.

- A DSFP must review and approve the material in writing before it is used.
- The material must:
  - prominently identify the Member; and
  - provide contact information for obtaining a copy of the disclosure statement for security futures.
- The material may not:
  - use any statement suggesting that security futures positions can be liquidated at any time; or
  - include any cautionary statement or disclaimer that:
    - is illegible;
    - disclaims responsibility for the content of the material; or
    - is misleading or inconsistent with the content of the material.

- The material must also note the source for any statistical tables, charts or graphs.

#### Targeted Promotional Material

Targeted promotional material is any promotional material that is not disseminated by mass media. Targeted promotional material includes:

- Reprinted articles;
- Research reports;
- Trade recommendations; and
- Mass mailings.

The following requirements apply to any targeted promotional material that does not meet the content requirements for mass media advertising (described on the following page).

- The material must be preceded or accompanied by the Risk Disclosure Statement for Security Futures Contracts.
- The material must:
  - include the date that the material was first used;
  - specifically state that security futures trading is not suitable for all customers; and
  - state that supporting documentation for all claims and comparisons is available upon request.

If the material solicits for a particular trading program, it must include the cumulative performance history of the firm's customers who have used the program. If the firm's customers have not yet used the program, it must include a statement that the trading program is unproven and treat any performance information as hypothetical results.

Promotional material that refers to past trading results must include a listing of all recommendations made within the past year for the underlying security or any security future or option on the same underlying security. It must include the following information for each recommendation:

- the specific security futures contract, security, or option recommended (e.g., July '02 XYZ futures, XYZ stock, July '02 XYX \$3.30 options);
- date and price at the time the contract, security, or option was recommended;
- date and price at liquidation when the recommendation for the transaction was to be acted upon; and
- a discussion of the market conditions during the time period covered.

Promotional material that includes current recommendations regarding security futures products must:

- include only those recommendations the Member or Associate has a reasonable basis for;
- disclose any material conflicts of interest created by the Member's or Associate's activities in the underlying security; and
- contain contact information for obtaining the list of past recommendations for the underlying security or any security future or option on the same underlying security.

### Promotional Material for a Mass Audience

Mass media advertising uses a medium where you cannot control the viewing audience. This includes:

- TV and radio;
- Newspapers and magazines; and
- Web sites made available to the general public (i.e., those that are not password protected).

Because of the uncontrolled nature of mass media advertising, NFA's rules limit its content. Mass media advertising may only include:

- The information required for all security futures promotional material (i.e., the name of your firm and contact information for obtaining the risk disclosure statement); and
- A general description of the security futures being offered such as:
  - Contract specifications;
  - Margin requirements; and
  - How the products will be traded.

You must submit the content of any mass media advertising to NFA for review and approval at least ten days before you wish to start using the material. Once again, if your firm is an NASD Member, you need to follow NASD's requirements.

### NFA's Pre-Review Program

NFA also provides a voluntary pre-review program for other promotional material. We encourage you to take advantage of this program for any security futures promotional material that you develop. If you are interested, you can simply send us your promotional material with a note that the material is being submitted for pre-review. NFA staff will then review the material for compliance and let you know if we have any concerns so you can make the necessary corrections before you have the materials printed and distributed.

### Additional Resources

NFA Compliance Rule 2-29 – Communications with the Public and Promotional Material

#### Interpretive Notices to NFA Compliance Rule 2-29:

- Communications with the Public and Promotional Material
- Review of Promotional Material Prior to its First Use
- Use of Promotional Material Containing Hypothetical Performance Results
- Deceptive Advertising
- High Pressure Sales Tactics
- NFA's Review and Approval of Certain Radio and Television Advertisements
- Use of Past or Projected Performance; Disclosing Conflicts of Interest for Security Futures Products

Unlike the securities industry, the futures industry has not had specific rules governing fair commissions and best execution. Since these requirements apply to security futures, NFA adopted rules to address them.

### Fair Commissions

NFA adopted Compliance Rule 2-37(g) and issued an Interpretive Notice, which require firms to charge customers a fair commission. A fair commission rate will take into account both the expense of executing the order and the value of the services you provide.

You must also ensure that you disclose all fees and commission charges to your customers.

### Best Execution

The securities laws impose a duty of best execution on firms and their APs, and the SEC required NFA to adopt standards in this area. NFA addressed best execution through an Interpretive Notice to Compliance Rule 2-4. The Interpretive Notice describes your best execution responsibilities while providing you and your firm with flexibility in meeting this obligation. The Interpretive Notice also reminds Members of their obligation to put their customer's interest before their own when soliciting and executing futures transactions.

The duty of best execution applies to any security futures contracts that are not materially different. In general, contracts on the same underlying security are not materially different even if they are not fungible.

Best execution does not apply when your customer instructs you to direct an order to a particular market. In other words, you can ask your customers which exchange they would like the trade executed on. However, if they ask you for advice, you must consider the same factors you would consider in placing an undirected order.

There are certain factors you must consider in deciding where to send an undirected order. Although price is the primary factor, you should also consider:

- The character of the market including, but not limited to, price, volatility, liquidity, depth, speed of execution and pressure on available communications;
- The size and type of transaction;
- The location and accessibility to the customer's intermediary of primary markets and quotation sources; and
- The differences in cost of execution among different markets.

You should not channel an order through a third party unless:

- The customer or customer's designee instructs you to do so;
- It is necessary to get the order executed; or
- You can show that by doing so you obtained the most favorable execution available for the customer.

NFA recognizes that speed of execution is extremely important in the futures markets, and checking multiple markets each time an order is received may actually disadvantage customers by delaying order execution. Therefore, we do not expect you to evaluate execution quality on an order-by-order basis. However, you must consider the above factors when establishing your order-routing practices and perform a regular and rigorous review of those practices to ensure that order flow is directed to the markets providing the best executions for your customers.

NFA expects to provide further guidance in this area as the markets for security futures products evolve.

#### Margin Requirements

The CFTC and SEC have set minimum initial and maintenance margin levels for security futures at 20% of the current market value of the positions. "Current market value" means the daily settlement price of the security future. However, your firm can set more stringent margin requirements.

Some other highlights of the margin requirements for security futures products are:

- The rules for applying margin requirements depend on whether the positions are held in a futures or a securities account;
- In general, Regulation T applies to positions in securities accounts but not to positions in futures accounts;
- However, Regulation T governs the types of collateral that can be held in both securities and futures accounts;
- If the account would liquidate to a deficit, the carrying firm must liquidate positions, and it must do so in a prompt and orderly manner;
- Exchanges can set lower margins based on particular strategies; and
- Security futures positions held in futures accounts cannot be cross-margined with positions held in securities accounts.

The rules governing margins are very complicated. We strongly encourage you to read the joint CFTC/SEC rules and the exchanges' margin rules for additional information about margin requirements.

#### Additional Resources

NFA Compliance Rule 2-37 – Security Futures Products

Interpretive Notice to NFA Compliance Rule 2-37: Fair Commissions

Interpretive Notice to NFA Compliance Rule 2-4: The Best Execution Obligation of NFA Members Registered as Broker-Dealers Under Section 15(b)(11) of the Securities Exchange Act of 1934

Customer Margin Rules Relating to Security Futures, 67 *Fed. Reg.* 53146 (Aug. 14, 2002)

NFA has always required its Members to observe high standards of commercial honor and just and equitable principles of trade. Unlike the securities industry, however, the futures industry does not generally restrict the use of non-public information. In order to make sure our Members comply with the securities laws for security futures transactions, we incorporated certain requirements from the Securities Exchange Act of 1934 into NFA Compliance Rule 2-37. These provisions are:

- Section 9(a), which prohibits specific forms of manipulation and applies to any exchange-traded security including security futures;
- Section 9(b), which prohibits transactions in security futures that violate any relevant SEC rule including rules about margins, customer protection and recordkeeping; and
- Section 10(b), which prohibits certain insider trading.

NFA Compliance Rule 2-37 also requires notice-registered broker-dealers to establish, maintain and enforce written procedures reasonably designed to achieve compliance with all applicable securities laws. In addition, a new Interpretive Notice limits the use of non-public information.

In the rest of this section, we will highlight the main points your firm needs to know regarding these new requirements.

### Trading Ahead of Research Reports

Your firm and its employees may not enter, alter or liquidate positions based on advanced knowledge of an upcoming research report. Your firm should consider developing and implementing firewalls to ensure that the information is kept within the research department. Possible firewalls include:

- physically separating the research department, the trading department, and the sales department;
- restricting communications between these departments; and
- limiting access to files that include material, non-public information.

### Block Trading

Your firm and its employees are prohibited from trading based on knowledge of an impending block transaction for an underlying contract or a future on the underlying contract. This type of trading, which is known as front running, is prohibited in the following accounts:

- Proprietary accounts;
- Accounts in which your firm or an associated person employed by your firm has an interest or discretionary authority; and
- Accounts for customers with whom your firm or an associated person has shared material non-public information.

This rule does not apply to transactions:

- Executed on automated execution systems in those instances where participants must accept the automatic executions; or
- Used to offset risk of a privately negotiated block transaction done according to exchange rules.

## Insider Trading

Some types of insider trading are prohibited by the securities laws. Prohibited insider trading is:

- Buying or selling a security or security futures contract, or tipping others;
- In breach of a fiduciary duty or other relationship of trust and confidence;
- While in possession of material, non-public information that could affect the price of the security.

The following are examples of potential insider traders:

- Officers, directors and employees of the corporation issuing the underlying stock;
- Employees of law, banking, brokerage and financial planning firms who are given confidential information in order to provide services to the corporation; and
- Tippees – who could, for example, be individual brokers.

Prohibited insider trading is generally discovered by regulators through market surveillance rather than by brokerage firms, but you must monitor for employee trading based on inside information. For example, you should identify situations where an employee may be a tippee or fiduciary and monitor the employee's trading activity in those companies' securities.

You might consider taking the following steps to identify and monitor situations where an employee may be a potential tippee or fiduciary:

- Include a question on your opening account documents asking the customer to identify any relationship with a public company;
- Require employees to notify your firm of relationships with public companies by employees and family members; and
- Require supervisors and/or your Compliance Department to maintain a list of these affiliations (including customer and familial) for each employee.

*If you are not familiar with the securities laws dealing with insider trading, you may want to consider speaking with your legal counsel.*

## Written Supervisory Procedures

Your firm should already have procedures reasonably designed to deal with fraud and manipulation. Those procedures should be reviewed and updated to ensure that they comply with any additional requirements imposed by the security futures rules. In general, the procedures need to cover the following:

- Reviewing employee trading and firm proprietary trading;
- Employee training regarding both the regulatory prohibitions on trading and any additional restrictions imposed by your firm; and
- Firewalls between your proprietary trading department, research department and sales staff if your firm has more than one of these functions.

Both the procedures and their use should be documented, and potential violations of the regulatory requirements or firm policy should be investigated

and disciplined where appropriate. Appendix 5 of this Guide includes suggestions for possible procedures.

**Additional Resources**

**NFA Compliance Rule 2-37 – Security Futures Products**

**Interpretive Notice Regarding Obligations to Customers and Other Market Participants**

## Appendix 1: Selected Listing of NFA, CFTC and SEC Requirements for Security Futures Products

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### NFA Requirements

#### Compliance Rules

- Rule 2-7 – Branch Office Managers and Designated Security Futures Principals
- Rule 2-8 – Discretionary Accounts
- Rule 2-29 – Communications with the Public and Promotional Material
- Rule 2-30 – Customer Information and Risk Disclosure
- Rule 3-37 – Security Futures Products

#### Interpretive Notices

- Obligations to Customers and Other Market Participants (§ 9041)
- NFA Compliance Rule 2.9: Special Supervisory Requirements for Members Registered as Broker-Dealers Under Section 15(b)(11) of the Securities Exchange Act of 1934 (§ 9042)
- NFA Compliance Rule 2-29: Use of Past or Projected Performance; Disclosing Conflicts of Interest for Security Futures Products (§ 9043)
- NFA Compliance Rule 2-4: Broker-Dealer Registration Requirements for Security Futures Products (§ 9044)
- NFA Compliance Rule 2-37: Fair Commissions (§ 9047)
- NFA Compliance Rule 2-4: The Best Execution Obligation of NFA Members Registered as Broker-Dealers Under Section 15(b)(11) of the Securities Exchange Act of 1934 (§ 9048)
- NFA Compliance Rules 2-7 and 2-24 and Registration Rule 401: Proficiency Requirements for Security Futures Products (§ 9049)
- NFA Compliance Rule 2-30(b): Risk Disclosure Statement for Security Futures Products (§ 9050)

### CFTC Regulations for Intermediaries

- 3.10 – Registration of futures commission merchants, introducing brokers, commodity trading advisors, commodity pool operators, and leverage transaction merchants.
- 15.03 – Reporting levels.
- 41.41 through 41.49 – Customer Accounts and Margin Requirements

### SEC Regulations for Intermediaries

- 240.10b-10 – Confirmation of transactions.
- 240.15a-10 – Exemption of certain brokers or dealers with respect to security futures products.
- 240.15b11-1 – Registration by notice of security futures product broker-dealers.
- 240.15c3-3 – Customer protection—reserves and custody of securities.
- 240.17a-4 – Records to be maintained by certain exchange members, brokers and dealers.
- 242.400 through 242.406 – Customer Margin Requirements for Security Futures
- 249.501b – Form BD-N for notice registration as a broker-dealer.

### Selected Federal Register Releases

- Registration of Broker-Dealers Pursuant to Section 15(b)(11) of the Securities Exchange Act of 1934, 66 *Fed.Reg.* 45138 (Aug. 27, 2001)

- Commission Guidance on the Application of Certain Provisions of the Securities Act of 1933, the Securities Exchange Act of 1934, and Rules Thereunder to Trading in Security Futures Products, *67 Fed.Reg.* 43234 (June 27, 2002)
- Customer Margin Rules Relating to Security Futures, *67 Fed.Reg.* 53146 (Aug. 14, 2002)
- Applicability of CFTC and SEC Customer Protection, Recordkeeping, Reporting, and Bankruptcy Rules and the Securities Investor Protection Act of 1970 to Accounts Holding Security Futures Products, *67 Fed.Reg.* 58284 (Sep. 13, 2002)
- Confirmation Requirements for Transactions of Security Futures Products Effected in Futures Accounts, *67 Fed.Reg.* 58302 (Sep. 13, 2002)

## Appendix 2: Sources of Additional Information

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National Futures Association  
200 West Madison Street  
Suite 1600  
Chicago, IL 60606  
(312) 781-1410  
[www.nfa.futures.org](http://www.nfa.futures.org)

Commodity Futures Trading Commission  
Three Lafayette Centre  
1155 21<sup>st</sup> Street, N.W.  
Washington, DC 20581  
(202) 418-5080  
[www.cftc.gov](http://www.cftc.gov)

U.S. Securities and Exchange Commission  
450 Fifth Street, N.W.  
Washington, DC 20549  
(202) 942-7040  
[www.sec.gov](http://www.sec.gov)

National Association of Securities Dealers  
1735 K Street, N.W.  
Washington D.C. 20006  
(202) 728-8000  
[www.nasdr.com](http://www.nasdr.com)

Futures Industry Association/Institute for Financial Markets  
2001 Pennsylvania Avenue, N.W.  
Suite 600  
Washington D.C. 20006  
(202) 223-1528  
[www.fiafi.org](http://www.fiafi.org)

OneChicago  
141 West Jackson Blvd.  
Suite 2208A  
Chicago, IL 60604  
(312) 424-8500  
[www.onechicago.com](http://www.onechicago.com)

Nasdaq Liffe Markets (NQLX)  
1 North Franklin  
Suite 2300  
Chicago, IL 60606  
(312) 553-4800  
[www.nqlx.com](http://www.nqlx.com)

NFA has received a number of inquiries from registered commodity pool operators (CPOs) and commodity trading advisors (CTAs) and unregistered hedge funds regarding regulatory requirements for security futures. This page includes some of the most common questions and answers.

*Q. My firm is a registered CPO/CTA and a Member of NFA. Does the firm have to designate a security futures principal and have its associated persons (APs) take the proficiency training?*

A. CPOs and CTAs are not required to have a designated security futures principal. If the pool or trading program will trade security futures, APs must take the proficiency training before they solicit pool participations or clients or engage in any other security futures activities that require AP registration. Even if the CPO or CTA does not solicit business, however, the person overseeing the firm's security futures activities should take the training.

Individuals who have received a testing waiver under NFA Registration Rule 402 do not have to take the training if they continue to meet the conditions for the waiver. However, this exemption does not apply to individuals who qualify for a testing waiver under the provisions of Registration Rule 401.

*Q. I operate a hedge fund but am not registered as a CPO. Do I have to register before I can trade security futures for the fund?*

A. Not necessarily. A recent CFTC release provides temporary no-action relief for operators and advisors of hedge funds if both of the following tests are met:

- 1) all of the fund's participants are accredited investors, knowledgeable employees, and foreign persons; and
- 2) the aggregate notional value of futures and commodity options does not exceed 50% of the fund's liquidation value.

The hedge fund operator must also notify NFA and the CFTC that the fund is claiming the no-action relief and must disclose to its participants that it is not registered as a CPO. Notices should be filed with NFA at the following address:

National Futures Association  
200 West Madison Street  
Chicago, Illinois 60606  
Attn: Mary McHenry, Compliance

A copy should also be filed with the CFTC at the following address:

Commodity Futures Trading Commission  
Three Lafayette Centre  
1155 21<sup>st</sup> Street, N.W.  
Washington, D.C. 20581  
Attn: Division of Clearing and Intermediary Oversight,  
Audit and Financial Review Section

The CFTC release provides additional information on how to calculate notional value, what information must be included in the notice filed with NFA and the CFTC, and what disclosures must be made. Similar requirements apply

to the advisors for these funds. The release can be found at <http://www.cftc.gov/files/opa/press02/opa17cfrpart4.pdf>.

*Q. I operate a registered investment company that currently qualifies for an exclusion under CFTC Regulation 4.5. However, I may not meet the 5% test once I start trading security futures. Do I have to register as a CPO?*

A. It depends on whether the investment company can meet an alternative test. The CFTC recently adopted a temporary no-action position for registered investment companies and other regulated entities covered by CFTC Regulation 4.5. Under the no-action position, CPO registration is not required if the aggregate notional value of the fund's speculative futures and options positions does not exceed the fund's liquidation value. This release can be found at <http://www.cftc.gov/files/foia/fedreg02/foi021028a.pdf>.

## Appendix 4: Information to be Obtained from Customers Who are Individuals

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The following lists the information that you are required to obtain for an individual's account. The additional information that is required for security futures accounts is marked with an asterisk (\*).

Account Name:

Account Number:

Address:

Age:

Futures Experience:

Other Investment Experience:

Speculative or Hedge Account\*:

Employment Status\*:

Name of Employer:

Principal Occupation or Business:

Annual Income:

Estimated Net Worth:

Estimated Liquid Net Worth\*:

Marital Status\*:

Number of Dependents\*:

Other information used or considered by the Member in making recommendations to the customer\*:

NFA has prepared this document to assist notice-registered broker-dealers in developing their procedures to comply with NFA Compliance Rule 2-37(b) regarding the misuse of material, non-public information. It is not a rule or interpretive notice, and firms are not required to adopt any of the specific procedures listed below.

NFA Compliance Rule 2-37(b) requires notice-registered broker-dealers to establish, maintain and enforce written procedures reasonably designed to achieve compliance with applicable securities laws. Members should already have procedures to deal with the types of fraud and manipulation that apply to all futures transactions (e.g., misleading sales solicitations). Notice-registered broker-dealers should, however, review and update those procedures to ensure that they comply with any additional requirements imposed by NFA's security futures rules.<sup>1</sup>

The Commodity Exchange Act and NFA Rules do not generally prohibit trading on material, non-public information. This conduct is, however, prohibited by the securities laws and by NFA's security futures rules. Therefore, notice-registered broker-dealers must establish, maintain, and enforce written procedures reasonably designed to prevent the misuse of material, non-public information by the firm and its employees.<sup>2</sup>

In general, the procedures should cover the review of employee trading and proprietary trading for the firm; employee training regarding both the regulatory prohibitions on trading and any additional restrictions imposed by the firm; and firewalls between the proprietary trading department, the research department, and the sales staff (assuming the firm has more than one of these functions). Both the procedures and their use should be documented and potential violations of the regulatory requirements or firm policy should be investigated and disciplined where appropriate.

Many of the items listed in this document are not applicable to firms that do not issue research reports or conduct proprietary trading, while other firms may have unique business functions that require additional procedures not listed here. Each notice-registered broker-dealer should develop procedures tailored to its own situation. What follows is simply a laundry list of procedures that the firm may wish to consider, as applicable.<sup>3</sup>

<sup>1</sup> See, e.g., NFA Compliance Rules 2-7(b), 2-29(j), 2-30(c) & (j), and 2-37 and the Interpretive Notices at ¶ 9041 (Obligations to Customers and Other Market Participants), ¶ 9042 (Compliance Rule 2-9: Special Supervisory Requirements for Members Registered as Broker-Dealers Under Section 15(B)(11) of the Securities Exchange Act of 1934), and ¶ 9043 (NFA Compliance Rule 2-29: Use of Past or Projected Performance; Disclosing Conflicts of Interest for Security Futures Products).

<sup>2</sup> Section 15(f) of the Securities Exchange Act of 1934 also requires notice-registered broker-dealers, as well as other broker-dealers, to have policies and procedures to address this issue.

<sup>3</sup> In preparing this document, staff drew on a number of sources, including the SEC's Division of Market Regulation's March 1990 report, *Broker-Dealer Policies and Procedures Designed to Segment the Flow and Prevent the Misuse of Material Non-Public Information*, and NASD Notice to Members 91-45, *Chinese Wall Policies and Procedures* (issued jointly with NYSE in July 1991). Although much of the discussion in those sources relates to investment banking activities, which notice-registered broker-dealers cannot engage in, those sources are not limited to investment banking activities and provide useful guidance for developing procedures regarding other types of material, non-public information.

## Review of Employee and Proprietary Trading

- Reference other procedures that govern review of employee and proprietary trading.<sup>4</sup>
- Require employees to inform specified personnel if they or family members have a relationship with a public company whose stock underlies a security futures contract. Spell out those relationships that must be disclosed (e.g., director, officer, 10% owner).
- Maintain an affiliation list, by employee. For each employee, include those public companies whose stock underlies a security futures contract where 1) the employee has notified the firm of a relationship, 2) the employee has a customer who has a known relationship, or 3) the firm has reasonable grounds to believe the employee is a potential tippee.
- If the firm issues research reports that discuss particular security futures contracts, maintain a watch list of all public companies who are expected to be included in upcoming reports to be issued within a specified time. Give access to this list only to compliance personnel and research department management (or other senior management with a need to know).
- Require compliance personnel or security futures principals to regularly review employee and proprietary trading for security futures transactions in securities on the employee's affiliation list and the watch list and to question unusual activity. Document the review, including date of review, name of reviewer, activity reviewed (e.g., all security futures trades on June 6 and 7), any unusual or suspicious activity noted, representations made by the employee regarding the nature of and reason for the activity, and action taken (e.g., closed, referred for investigation).
- Require compliance personnel or security futures principals to review records of block trades in security futures against trading activity of those employees who had access to information on the block trade, and document the review.
- Require employees to identify, by broker-dealer and account number, all securities accounts they own or have an interest in. Take reasonable steps to obtain account statements and have compliance personnel review trading in securities that underlie a security futures contract if the firm has reason to believe that the employee may have misused material, non-public information. Document the review.

<sup>4</sup> CFTC Regulation 155.3 prohibits FCMs from carrying accounts for employees of other FCMs or IBs without obtaining written permission from the employer and providing account statements and order tickets to the employer on a regular basis. NFA Compliance Rule 2-8 requires Members to regularly review trading in discretionary accounts, and the NFA Interpretive Notice at ¶ 9019 (Supervision of Branch Offices and Guaranteed IBs) requires Members to regularly review and analyze trading in employee accounts. Notice-registered broker-dealers should already have procedures relating to these activities. Furthermore, many firms also have policies restricting employee trading and/or proprietary trading for the firm. To the extent that these policies and procedures are already part of the firm's policy manual, they need not be duplicated.

- Direct compliance personnel to investigate suspicious activity and document the investigation.

#### Employee Training

- Ensure that each employee is provided with understandable information about securities laws, NFA rules, and the firm's own policies and procedures regarding the use of material, non-public information.
- Require each employee to agree in writing that he or she will comply with the securities laws, NFA rules, and the firm's policies and procedures regarding the use of material, non-public information. Include this affirmation in a separate document, a confidentiality agreement, or the firm's code of conduct. For employees in the research department, provide for periodic (e.g., annual) reaffirmations.
- Provide updates to employees regarding changes to the law, NFA rules, and the firm's policies and procedures.
- Instruct staff with access to material, non-public information not to discuss the information in places where it can be overheard or using communications systems that are not secure.

#### Firewalls

- Separate the research, trading, and sales departments. Use physical barriers (e.g., separate rooms) where feasible.
- Restrict communications between the research, trading, and sales departments.
- Limit access to files, databases, and facilities where material, non-public information is kept.

#### Record-keeping

- Write clear procedures and include them in the firm's procedures manual. Procedures may be flexible but should not be vague.
- Maintain copies of employee affiliation lists, watch lists, and documentation of reviews and investigations for the period required by CFTC Regulation 1.31.

#### Enforcement

- Take appropriate disciplinary action for any violation.
- Report serious violations to NFA. Report violations of the securities laws to both NFA and the SEC. Report potential violations to NFA and/or the SEC, as appropriate, if investigation is still in progress but conduct may be continuing or if findings are inconclusive.

#### Other

- Remind employees that they cannot ignore suspicious activities by customers.<sup>5</sup> Include examples of suspicious activities and procedures to follow in notifying appropriate personnel.

<sup>5</sup> Although the intent of these procedures is to prevent the misuse of material, non-public information by the firm and its employees, the firm should not ignore suspicious activity by a customer. Section 20(f) of the Securities Exchange Act of 1934 provides that the SEC can take an enforcement action against "any person that knowingly provides substantial assistance to another person in violation of [the securities laws]." Any Member or Associate that closes its eyes to illegal activity may also violate NFA Compliance Rule 2-4.

