

Interpretive Notices

9019 - COMPLIANCE RULE 2-9: SUPERVISION OF BRANCH OFFICES AND GUARANTEED IBS

(Board of Directors, October 6, 1992; revised July 24, 2000)

INTERPRETIVE NOTICE

NFA Compliance Rule 2-9 places a continuing responsibility on every Member to diligently supervise its employees and agents in all aspects of their futures activities. Rule 2-9 applies not only to the supervision of branch office operations, but also imposes a direct duty on guarantor FCMs to supervise the activities of their guaranteed IBs. NFA Compliance Rule 2-23 provides that a guarantor FCM may be held jointly and severally subject to discipline by NFA for violations of NFA rules committed by the FCM's guaranteed IBs. In practice, NFA's Business Conduct Committee has charged FCMs under Rule 2-23 only where it appears that the guarantor failed to diligently supervise its guaranteed IBs.

NFA recognizes that, given the differences in the size of and complexity of the operations of NFA Members, there must be some degree of flexibility in determining what constitutes "diligent supervision" for each firm. It is NFA's policy to leave the exact form of supervision to the Member, thereby providing the Member with flexibility to design procedures that are tailored to the Member's own situation. Nevertheless, NFA's Board of Directors believes that it is appropriate to provide Members with specific minimum standards for a supervisory program for branch offices and guaranteed IBs ("remote locations") and therefore issues the following Interpretive Notice.

Though Members may tailor their supervisory procedures to meet their particular needs, any adequate program for supervision must include procedures for performing day-to-day monitoring and surveillance activities, conducting on-site visits of remote locations and conducting ongoing training for firm personnel. The firm's policies and procedures, including those for the supervision of branch offices and guaranteed IBs, should be in written form. Firm personnel and guaranteed IB personnel should be provided a copy of the appropriate policies and procedures relating to their duties, and be aware of the firm's requirements. A copy of all policies and procedures should be on file with the branch office or guaranteed IB. All supervisory personnel should be knowledgeable of the firm's requirements for supervision.

I. Day-to-Day Monitoring

On a regular basis a Member should perform a number of supervisory procedures in order to monitor the business being conducted in its remote locations. The extent of the supervision depends on a number of factors, including the volume of trading, the experience of the personnel, the nature of the customers, the trading strategies followed by the office or certain APs, the number of customer complaints and the length of time that the office has conducted business with the firm. Repeated problems in any particular area should heighten the level of scrutiny and follow-up by the main office or guarantor.

The procedures to review the day-to-day activities of an office should include the following areas.

Hiring. An adequate program for supervision must include thorough screening procedures for prospective employees to ensure they are qualified and to determine the extent of supervision the person would require if hired. The appropriate documentation to support any "yes" answers on the Form 8-R should be obtained and reviewed for potential disqualifying information. Derogatory information, which the applicant may have submitted in connection with any past regulations, should be obtained from NFA.¹ Prior employers should be contacted to confirm the person's previous work experience.

In connection with the review of the person's prior work experience, a prospective employer should check for any futures-related disciplinary proceedings against the person's prior employer.² This information should be used by the prospective employer to determine the extent of supervision a particular applicant would require after he or she is hired.

Due Diligence Check of Guaranteed IBs. Guarantor FCMs must do a due diligence inquiry before entering into a guarantee agreement. The due diligence review must include a check to ensure that the IB is properly registered. The FCM's due diligence review should also include inquiries concerning the disciplinary history of the IB and the disciplinary and employment history of the IB's principals and APs. This type of information could be helpful to a prospective guarantor in determining the types of difficulties, if any, experienced by an IB, its principals and APs in the past and the extent of supervision which may be required of that IB under a guarantee agreement. For example, if the APs at a certain IB have received their futures training and experience at a firm or firms that have been subject to serious disciplinary actions by NFA or the CFTC, that IB may well require more supervision. Both registration and disciplinary information is readily available from NFA.³

Registration. Records of commissions payable to or generated by the branch office or guaranteed IB should be broken down by sales person and should be frequently reviewed to ensure that no commissions are being paid to unregistered individuals.

Customer Information. NFA Compliance Rules require each Member to adopt and enforce procedures regarding customer information and risk disclosure. The procedures for opening new accounts should require that the appropriate account documentation, including an acknowledgment of receipt of the required risk disclosure statement, be forwarded to the main office or guarantor.⁴ The documentation should be reviewed to ensure that the appropriate supervisory personnel approved the account. The information obtained from a customer should be reviewed to determine whether additional risk disclosure should have been provided to the customer. For any customer who should have received additional risk disclosure, the main office or guarantor should ensure that additional disclosure has been given and that such disclosure has been documented. It may also be necessary to contact the customer to verify that the disclosure was provided and that the customer understood its meaning. Notwithstanding these procedures, a firm may wish to require that all new account information and documentation be forwarded to the main office or guarantor for approval before trading commences in the account.

Account Activity. The trading activity in customer and AP personal accounts should be reviewed and analyzed on a regular basis in order to highlight those accounts which may require further scrutiny. There are a number of calculations and comparisons which can be performed to flag accounts for follow-up or further monitoring. For example, significant losses, commission charges or number of trades should be reviewed for inappropriate trading strategies. The reason for error and correction entries to trading accounts should be investigated, especially if there appears to be a pattern of errors or corrections made by an office. Commission-to-equity ratios

should be calculated for discretionary trading. In order to identify improper trade allocations to discretionary accounts or front running, the trading results in an AP's personal account should be compared to the trading gains and losses in his or her customer accounts. Profitable customer accounts for a given AP should be reviewed for possible preferential treatment.

Appropriate supervisory personnel at the remote location should be notified of questionable account activity. Measures should be taken to follow up, such as reviewing order tickets and trade blotters, discussing the activity with the broker or contacting the customer.

Discretionary Accounts. NFA Compliance Rule 2-8 contains detailed requirements concerning the supervision and review of discretionary accounts. The written customer authorization and customer acknowledgment for third-party account controllers should be forwarded to the main office or guarantor.⁵ Confirmation of the registration history of APs of FCMs and IBs exercising discretion should be made to ensure that they have been properly registered for the requisite two-year minimum.

Promotional Material. NFA Members are required by rule to adopt and enforce procedures regarding communications with the public. All promotional material should be submitted by the branch office or guaranteed IB to the home office or guarantor for review and approval prior to its first use. Review and approval of the material should be documented by the appropriate supervisory personnel.

Customer Complaints. An adequate system for handling customer complaints should require that a written record of all complaints be maintained, and that complaints which meet certain criteria be sent to the main office or guarantor. Notification of the main office of customer complaints may be based on factors including the seriousness of the allegations of wrongdoing, the monetary amount involved, and which APs or principals are subjects of the complaints. If the remote location is responsible for resolving customer complaints, the home office or guarantor should also be notified of the outcome of resolved complaints. Notwithstanding these criteria, a firm may wish to consider having all customer complaints received by a remote location submitted to the main office.

The main office or guarantor should review the complaints for possible rule violations. It should also compare the allegations in the complaint for similarity to other complaints received against the same individuals or office. Such a review may detect a pattern of sales practice or other abuses.

The status of unresolved complaints should be periodically reviewed to ensure that the branch office or guaranteed IB has promptly responded to complainants.

II. On-Site Visits

In addition to day-to-day supervisory procedures, adequate supervision of the personnel who do work in the main office must also include periodic on-site inspections. As a general matter, NFA would expect these on-site inspections of guaranteed IBs or branch offices to be performed annually.

Members should develop written procedures for the on-site review process including detailed steps to be followed during the visit. This will help ensure that the review process is performed in a consistent manner and will not vary due to the involvement of different personnel in the review process. A Member's supervisory procedures should also address the number of visits to be made to a branch office or guaranteed IB. The frequency and nature of the visits, as well as whether the visit will be announced or unannounced, will depend on a number of factors including: the amount of business generated; the number of customer complaints received; the previous training and experience of the branch office personnel; and the frequency and nature of problems or concerns that arise as the result of day-to-day monitoring and surveillance of the office's activities. The personnel who make the visits should be qualified to perform examinations and knowledgeable of the industry and the nature of the firm's business. Such personnel should be able to perform their work with an independent, objective perspective.

The length of time between visits to the remote location coupled with the size and scope of its operation also plays a role in determining the procedures for on-site review of records and account documentation.⁶ In reviewing a smaller operation, it is feasible to conduct a comprehensive review of the remote location's records and documents over the entire time period between visits, while reviewing a larger scale operation may require the selection of a sample of records and documents for given time intervals. The selection of samples should be accomplished on a random basis, for example, selecting every third account for review for randomly selected time periods.

Promptly after the completion of an on-site visit, a written report should be prepared and its findings discussed with the branch office and regional managers or guaranteed IB's principals and supervisory personnel. Follow-up procedures should also be performed to ensure that any deficiencies revealed during an on-site visit are promptly corrected. The written procedures for the on-site examination should include steps to review the following areas:

Customer Order Procedures. An on-site visit to a remote location should include a review of procedures for handling and recording customer orders. The individuals responsible for accepting customer orders should be identified and a sample of order tickets should be selected for review. NFA recommends that order tickets be prenumbered and that the on-site review test to ensure that all order tickets within the chosen samples are accounted for. The order ticket review should also confirm that all order tickets are properly time stamped and that all information required by CFTC Regulation 1.35 is included. If option orders are placed by the branch office or guaranteed IB, those order tickets should be reviewed to ensure that they contain the additional information required by CFTC Regulation 1.35.

Discretionary Accounts. If a branch office or guaranteed IB handles discretionary accounts, the supervisory visit should confirm that the branch office or guaranteed IB identifies discretionary orders as such and that the firm's procedures regarding the supervision of discretionary trading activity are followed. In the event a branch office or guaranteed IB enters block orders, those orders should be reviewed to confirm that customer orders are not included with proprietary orders and that nondiscretionary customer orders are not included with discretionary customer orders. Split fills should be reviewed to ensure that they have been allocated according to established procedures.

Sales Practices. The on-site visit should include a review of sales solicitation practices as well as any promotional material utilized. A suggested starting point for review of the sales solicitation practices of a branch office or guaranteed IB is to identify the persons involved in sales solicitation and to confirm that they are properly registered. The individuals conducting the on-site review should also monitor sales solicitations while at the branch office or guaranteed IB. Interviews with selected customers should be conducted concerning the solicitation process and the handling of the customer's account. The individuals at the branch office or guaranteed IB responsible for supervising sales solicitations should be identified, and the method by which sales solicitations are supervised should be reviewed for adequacy.

The branch office or guaranteed IB's promotional material, including sales solicitation scripts, must be approved by appropriate supervisory personnel. Therefore, an on-site visit should be designed to ensure that the branch or guaranteed IB is not using any promotional material that has not received prior approval. If the main office or guarantor has not approved the promotional material, it should be reviewed during the on-site visit.

Customer Complaints. The on-site review should include steps to confirm that all complaints requiring notification have been reported to the main office.

Handling of Customer Funds. In order to assure that customer funds are being properly handled by a branch office, the on-site review should determine whether the branch office accepts funds from customers and, if so, whether appropriate bank accounts, including segregated accounts for customer funds, have been established by

authorized personnel. In addition, for guaranteed IBs, the on-site review should confirm that if funds are accepted from customers, they are received in the name of the FCM. The branch office or guaranteed IB should make copies of any customer checks that they deposit into a qualifying or branch bank account. The check copies should be reviewed during the visit to ensure that the branch office or guaranteed IB only accepts checks made payable to the FCM. In addition, third-party checks should be scrutinized to ensure that no customers are acting as unregistered FCMs or CPOs. If the guaranteed IB receives customer funds in the FCM's name, the review should confirm that the proper authorization to do so exists, that appropriate bank accounts are maintained and that proper procedures for forwarding the funds have been established and are followed. For both branch offices and guaranteed IBs, the flow of customer funds in a sample of accounts should be reviewed to determine that all funds have been timely transmitted and properly credited.

Proprietary Trading. To the extent feasible, there should be a separation of duties between persons handling customer orders and firm employees or principals trading for the firm's proprietary accounts or their own accounts to prevent misuse of non-public information or the occurrence of other trading abuses.

III. Ongoing Training

A Member's supervisory responsibilities include the obligation to ensure that its employees are properly trained to perform their duties. Procedures must be in place to ensure that employees receive adequate training to abide by industry rules and regulations and to properly handle customer accounts and that APs have completed the ethics training required by CFTC Regulation 3.34. Employees must be educated on developments and changes in the markets, futures products, rules and regulations, technology, and firm policies and procedures. The formality of a training program will depend on the size of the firm and the nature of its business. The individuals responsible for providing the training must be qualified to do so.

Certain APs may require training for soliciting and handling customer accounts. If an AP has previously worked at firms closed through an enforcement action for sales fraud and has therefore received his or her training from such firms, that AP may need specialized training in proper sales practices.

This Notice is intended to specify minimum supervisory standards for branch offices and guaranteed IBs. A failure to adhere to the requirements specified in this Notice will be deemed a violation of NFA Compliance Rule 2-9.

¹ The detailed explanation of any "yes" answers on an 8-R is treated as nonpublic information; however, it is available to prospective employers under NFA Registration Rule 701(c). See Interpretive Notice at ¶9010.

² Information concerning futures-related disciplinary proceedings can be obtained by checking the BASIC system on NFA's web site at www.nfa.futures.org, sending a request to NFA through the "contact" feature of the web site, or calling NFA's Information Center at (800) 621-3570. See Interpretive Notice at ¶9010.

³ Registration Information is also available by checking the BASIC system on NFA's web site at www.nfa.futures.org, sending a request to NFA through the "contact" feature of the web site, or calling NFA's Information Center at (800) 621-3570. See Interpretive Notice at ¶9007.

⁴ NFA Rules require that a guaranteed IB maintain a record of the information obtained from a customer and a copy of the risk disclosure acknowledgment. A branch office may wish to keep copies of this information for its files.

⁵ NFA Rules require that a guaranteed IB maintain a record of the written customer authorization and customer acknowledgments for third-party account controllers. A branch office may wish to keep copies of this information for its files.

⁶ If a visit is prompted by awareness of a particular problem at a remote location or if a problem is discovered during a routine visit, the Member must ensure that the scope of the review is adequate to thoroughly examine the problem area.