



Securities Industry Association



August 9, 2002

Jonathan Katz, Secretary  
Securities and Exchange Commission  
450 Fifth St, N.W.  
Washington, D.C. 20549

Re: Release No. 34-46186; File No. SR-NASD-2002-40

Dear Sir:

The Steering Committee on Securities Futures of the Futures Industry Association<sup>1</sup> and Securities Industry Association<sup>2</sup> is pleased to submit its comments on the rules proposed by the NASD with respect to securities futures, products authorized under the Commodity Futures Modernization Act of 2000 (the "CFMA").

We commend the NASD for its careful and thorough approach to this rulemaking. The introduction of a new derivative product which can trade under both a securities and a futures regime presents a unique challenge for the NASD, other securities self-regulatory organizations, the National Futures Association ("NFA") and the exchanges that will trade these products (collectively, "SROs"). Fundamental differences in trading rules and practices between futures and securities exchanges as well as diverging views about the roles and responsibilities of market intermediaries (broker-dealers and futures commission merchants ("FCMs")) will require close coordination and unprecedented cooperation not only between the Commission

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<sup>1</sup> The Futures Industry Association ("FIA") is a principal spokesman for the commodity futures and options industry. FIA's regular membership is comprised of approximately 50 of the largest futures commission merchants ("FCMs") in the United States, the majority of which are also registered broker-dealers. Among its associate members are representatives from virtually all other segments of the futures industry, both national and international.

<sup>2</sup> The Securities Industry Association's ("SIA's") members include more than 740 securities firms (including investment banks, broker-dealers and mutual fund companies) that are active in all US and foreign markets and in all phases of corporate and public finance. The US securities industry manages the accounts of more than 80 million investors directly and indirectly through corporate, thrift and pension plans.

and the Commodity Futures Trading Commission (“CFTC”), as primary regulators, but also among the SROs. The NASD has taken a first step in this process by recognizing rulemakings by the NFA and coordinating its approach in the current proposals with certain of the NFA’s rules. As our comments below indicate, however, we think more harmonization between the NFA and NASD rules needs to be done before these products begin trading.

We have the following comments on the proposed rules.

I. Scope of the Rules – Application of NASD Rules Generally

- A. Securities futures, like options, will trade principally on exchanges and be subject to each exchange’s trading rules. It is critical that the NASD rules not conflict with the exchanges’ rules, particularly with regard to order handling and trading, when applied to firms that are both members of NASD and of the relevant exchange. Where an NASD member is also a member of an exchange trading securities futures, the NASD’s rules should make clear that the exchange’s trading rules take precedence with respect to orders executed on that exchange.

Furthermore, since these products can be booked either in a securities account or in a futures account, it is likely that dually registered firms will route business booked in securities accounts through the securities side of their business and business booked in futures accounts through their futures professionals. We urge the NASD to defer to NFA qualifications and rules to the greatest extent possible for dual registrant firms for customers whose transactions will be booked in futures accounts. This should significantly enhance the practical aspects of compliance and supervision.

1. Ideally, proposed Rule 2865 should be a comprehensive stand-alone rule containing to the greatest extent possible all rules applicable to securities futures. But Rule 2865(b)(1)(C) makes the provisions of the By-Laws and Rules and all other interpretations and policies of the Board of Governors applicable to the trading of securities futures “except to the extent that specific provisions of [Rule 2865] govern, or unless the context otherwise requires”. We believe that this general statement of applicability should instead track the approach with respect to options in Rule 2860(b)(1)(A) and make clear the appropriately limited scope of NASD’s rules to securities futures. Specifically, we recommend the following language in substitution for the language of Rule 2865(b)(1)(A):

“(A) Applicability—This Rule shall be applicable: (i) to the opening and conduct of accounts and (ii) with respect to members who are not members of the exchange where a securities future is traded, to the execution of transactions and the handling of orders. If a member carries accounts for customers in a futures account, these rules shall govern transactions booked and carried in the futures account except for those paragraphs made exclusively applicable to securities futures carried in a securities account.”

Any other rule outside of Rule 2865 should be made specifically applicable to securities futures, as are, for example, IM-2210-7 and IM-2310-2, but only after careful consideration as to whether the rule (or interpretation) **should be** applied to securities futures.

2. A case where the “context” of a current rule may apply to securities futures without explicit incorporation into Rule 2865 is the “Best Execution” rule, Rule 2320. There is no analogue in Rule 2865 as proposed and no clarification in Rule 2320 is proposed. Accordingly its applicability would arise in the “context” of the proposed rule. We note that NFA has adopted a “best execution rule” which is modeled after, but differs in some respects from, Rule 2320. We criticized the NFA’s rule on several grounds, one of which was that it applied to basically non-fungible products and because it tracked various aspects of the NASD rule (specifically the prohibitions against interpositioning) that we believe make no sense in the current securities trading environment. The SEC has also acknowledged that it would be difficult to apply best execution principles to contracts that are materially different as to their terms. (SEC Interp. Rel. 33-8107, 34-46101.) We urge that Rule 2320 not be extended automatically to securities futures without careful consideration of the consequences. We therefore recommend that the applicability of Rule 2320 to the trading of securities futures be specifically clarified.

## II. Specific Comments

### A. Registration and Qualification Requirements (Rule 1022)

1. We note that the Chicago Board Options Exchange has proposed doing away with the separate Senior Registered Options Principal and Compliance Registered Options Principal requirements on the grounds that securities principal qualifications should be sufficient to cover the

supervisory obligations of listed options. We agree that it no longer makes sense to have product specific designations for supervisors, and those similar requirements for securities futures should therefore not be adopted. It ought to be sufficient to make clear that the scope of supervisory duties for securities principals extends to all aspects of the business being conducted. Passing an additional Firm Element when the business being supervised includes options or securities futures is an appropriate supervisory requirement for a securities principal supervising options or securities futures professionals. If this suggestion is not implemented, we recommend that the NASD permit Series 24 qualified supervisors to act as sales-only supervisors.

2. We urge the NASD to clarify that a person employed by a fully-registered broker-dealer/FCM whose job is to enter orders into a member's electronic order routing system for execution need not be series 55 qualified traders. This function, when purely mechanical, does not involve any decision making at the point of order entry. Persons performing this function on a member's futures desk do not have to be registered in any capacity, and it would be extremely burdensome, and in our view entirely unnecessary for the protection of investors, to require a series 55 qualification for these persons.
3. In this same context, the requirement that security futures principals maintain the Series 4 and sales supervisors maintain the Series 4 or Series 9/10 is a severe impediment to the futures industry's ability to supervise this product on the first day of trading. Even though many firms are registered as both Broker/Dealers and Futures Commission Merchants, most futures personnel do not maintain the Series 7, the prerequisite exam for the above-referenced supervisory exams. If there are not securities sales persons in a futures division, there is no reason to maintain such a license. Currently, these managers adequately supervise futures trading but will be required to take the Series 7 and another examination for the sole purpose of supervising the security futures product. Even where the management in futures maintains a Series 7, the Series 4 and Series 9/10 are not likely to be additional principal licenses maintained by such managers. More likely is the Series 24, the General Securities Principal license. Given the hardship on the futures divisions of fully registered firms, and the likelihood that they will not be able to supervise this product on the first day of trading, we would request that the NASD consider either (a) allowing the Series 30 personnel in fully registered firms to supervise futures sales staff whose clients are carrying the security futures product in a futures

accounts only or (b) provide a grace period for futures managers to take the Series 7 and the appropriate supervisory or principal exam.

4. In addition, we further request that given that the Series 9/10 is a branch exam for the NYSE and persons registered as such are likely to be found in NYSE member firms rather than firms that are NASD-only firms, we believe there will be a hardship on such firms. The NASD recognizes the Series 24 as a principal exam for the purpose of supervising sales personnel. As such, the Task Force requests that the Series 24 exam be sufficient for broker/dealer managers to supervise sales staff.

B. Front-Running Policy (IM 2110-3)

We challenge the underlying assumption that the intermarket front-running interpretation now applicable to trading in the options and cash markets should be automatically extended to securities futures. Careful consideration should be given to examining how client facilitation or similar capital commitment trades by block positioning firms can be efficiently handled in today's increasingly diverse marketplace. In addition, certain transactions not permissible in the options market will be permissible in securities futures. For example, exchanges trading securities futures products may permit certain off-board, privately negotiated block transactions and "EFPs" (an exchange of a futures contract for a physical position in the underlier). Such transactions ought be excluded for the definition of a "block trade" for front-running purposes.

Separately, we urge that actual knowledge of the block by the associated person initiating the alternative market trade be a prerequisite for a violation of the rule. A similar issue arises under the "Trading Ahead" rule (proposed Rule 2865(b)(25)) discussed below. Given the development of separate trading units within firms that are subject to forward information barriers designed to keep information about customer orders and block positioning away from any persons trading for a firm's proprietary accounts operating independently, an actual knowledge requirement for violation of the policy is appropriate. Finally, we believe that the sentence applying the front-running policy to securities futures transactions regardless of whether they are reported pursuant to a trade reporting system makes the rule practically unworkable.

C. Communications with the Public – Rule 2210 and IM-2210-7

We urge the NASD to carefully coordinate with the NFA and other SROs in this area to avoid inconsistent regulations and requirements. Differences in the

definitions of “advertising” and “sales literature” on the one hand and “promotional literature” on the other hand, as well as both content and approval requirements relating to mass media communications should be reconciled. There should be no material regulatory differences in what FCMs on the one hand and broker-dealers, on the other hand, can say to current or prospective customers and when and how it can be said. Similar reconciliation and harmonization is needed in the respective approaches to historical performance (IM 2210-7(f)).

D. Securities Futures – Rule 2865

1. Confirmations – Rule 2865(b)(12)

Since the Commission is proposing amendments to Rule 10b-10 covering securities futures (see Release No. 34-46014, File No. 57-19-02 May 31, 2002) we believe there is no longer a need for a separate SRO confirmation requirement and we urge that this rule be deleted. If the Rule is nevertheless adopted, its requirements should be consistent with the SEC’s final amended Rule 10b-10, in particular taking into account the “phase in” requirement contained therein. In addition, we suggest deleting the requirement that confirmations state whether the transaction is “long” or “short”. These terms simply do not apply to futures contracts. The appropriate term is “buy” or “sell”. We also proposed deleting the requirement to show the quantity of the underlying security or index. This information will be contained in other information required to be delivered to the customer. The only information required in the confirmation should be the number of contracts bought or sold. Similarly, the amount of the initial and maintenance margin required should not be a mandatory confirmation disclosure because this amount is not transaction specific, but is a computation made at the close of the trading day based on the customer’s activity during the day (this will be true regardless of whether the transaction is booked and carried in a securities account or a futures account).

2. Customer Statements – Rule 2865(b)(15)

The requirement to show “the market value of each securities futures position” as well as the “total market value of all positions” should be deleted since securities futures will not have a market value as such. Disclosure of the mark-to-market price should be sufficient. We also propose that subparagraph (B) be deleted in its entirety since it is

related to the margin computation for securities futures and the maintenance requirements therefor, which will depend on rules, including amendments to Rule 2520 (the Margin Rule), that have not yet been proposed.

3. Diligence in Opening Accounts – Rule 2865(b)(16)(B) and (D)

We urge the NASD to coordinate with the NFA and other SROs to make this rule consistent among all of the SROs. Specifically, while we acknowledge the prudential nature of the rule, we object to the requirement in sub-paragraph (B) that a member establish a minimum net equity requirement for initial approval and maintenance of customers' security futures accounts if this requirement is not applicable to FCMs. We also note that NFA rules do not require FCMs to obtain a customer's acknowledgment of receipt of a risk disclosure statement, as subparagraph (D) would require. We recommend conforming the NASD rule to the NFA rule. We also believe it should no longer be necessary to require customers to acknowledge receipt of the risk disclosure statement for options, and therefore a conforming amendment should be made in Rule 2260(b)(16)(D). These amendments would not relieve a broker-dealer or FCM from the obligation to deliver the risk disclosure statement to the customer.

4. Recordkeeping – Rule 2865(b)(17)

We request that the NASD clarify that, with respect to customer complaints, the maintenance of a separate record for securities futures complaints (that is, separate from the records of customer complaints regarding other products, is unnecessary. Customer complaints in this area are as likely to cover related transactions in other products. The ability to identify a complaint as involving securities futures should be sufficient.

5. Suitability – Rule 2865(b)(19)

IM-2310-3 relating to suitability obligations to institutional customers should be specifically incorporated either by reference or in text. At the same time, the NASD should make a similar clarification with respect to Rule 2860(b)(19) relating to options.

6. Securities Futures Transactions and Reports by Market-Makers in Listed Securities – Rule 2865(b)(24)

As drafted this audit trail requirement will be costly and burdensome because of the scope of persons potentially covered. Industry representatives believe that, at least initially, internal surveillance tools can accomplish the NASD's goals in adopting this rule.

7. Trading Ahead of Customer Orders – Rule 2865(b)(24)

The NASD's statement in the proposing release at page 67 FR 47422 regarding this rule makes clear that the prohibition against trading ahead applies only to customer orders of which the member is aware or reasonably should be aware. The statement also refers favorably to an NFA Interpretive Notice which gives examples of situations which would illustrate when the rule would not apply. We request that the NASD adopt a conforming Interpretive Memorandum.

E. Short Sales – Rule 3370

While we agree that the affirmative determination of the availability of stock for borrowing to cover a short position is not appropriate at the initiation of a securities futures transaction, we believe that, for risk management purposes and to avoid fails, members who would have a delivery obligation under a short physically-settled securities futures contract should know, as contract expiration approaches (and a delivery requirement is triggered for the clearing firm), whether the contract will be held to expiration. The delivery obligation that is triggered upon expiration of a short securities futures contract can apply to transactions carried for customers, for proprietary positions and where a member has agreed to guarantee delivery on behalf of another broker-dealer or FCM. We recommend that the following text be considered as a new subparagraph "C" under Rule 3370(b)(2):

“C) Delivery against Short Securities Futures Contracts.

If a member holds a short securities futures contract requiring physical delivery of the underlying security in a customer or proprietary account, or is otherwise obligated to perform a delivery obligation on behalf of a third party in respect of a securities futures contract, the affirmative determination requirements of subparagraphs (A) and (B) shall apply to such member on the expiration day of the relevant contract unless the member has received assurances on or before that

day that the contract will be closed out prior to the time when the delivery obligation becomes final, or the member otherwise determines that its net settlement obligation if the contract is not closed out would not require a stock borrow.”

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In summary, we appreciate the efforts of the NASD to draft rules applicable to securities futures. However, we believe that this rulemaking is only a first step. The SROs and the Commission will need to be vigilant about the development of industry practices or trends that may require amendment or modification of existing rules. We urge the NASD to take a leadership role in developing a new framework for coordinated rulemaking for these new products. The purpose of such cooperation and coordination should be to assure the deployment of rules which are clear and consistent in areas where practices and standards should be universal, and to defer where consistency is not necessary for customer protection. We believe that early consultation with the broker-dealer/FCM community is critical.

The SIA/FIA Task Force has attempted to bring together industry representatives from both the securities and futures community who are knowledgeable about the differing practices and regulatory approaches of the futures and securities markets to contribute to this process. We look forward to working with the NASD and the other SROs, as we have with the staffs of the Commission and the CFTC, as this process continues. We urge the Commission to facilitate coordination among the SROs and with the industry, particularly after these new products begin trading.

Finally, representatives of the Task Force would be pleased to meet with Commission staff to discuss any of the points raised in this comment letter. Please contact any of Jerry Quinn at the SIA (212-618-0507), Barbara Wierzynski at the FIA (202-466-5460), or Tony Leitner, co-chair of the Legal/Regulatory Subcommittee of the Task Force 212-902-5730).

Very truly yours,

Jonathan Barton, Chairman  
FIA/SIA Steering Committee on Security Futures

cc: Annette Nazareth (SEC)  
Robert L.D. Colby (SEC)  
Catherine McGuire (SEC)  
T. R. Lazo (SEC)

Patrice M. Gliniecki (NASD)

Gary Goldsholle (NASD)

De'Ana Dow (NASD)

Alan Lawhead (NASD)