NFA NATIONAL FUTURES ASSOCIATION

January 18, 2011

Mr. David Stawick
Secretariat
Commodity Futures Trading Commission
Three Lafayette Centre
1155 21st Street NW
Washington, DC 20581

Re: Implementation of Conflict of Interest Policies and Procedures by Futures Commission Merchants and Introducing Brokers
RIN number 3038-AC96

Dear Mr. Stawick:

National Futures Association (NFA) appreciates the opportunity to comment on the Commodity Futures Trading Commission's (Commission) proposed rulemaking to establish conflict of interest requirements for futures commission merchants (FCMs) and introducing brokers (IBs) as required by Section 732 of the Dodd-Frank Wall Street Reform and Consumer Protection Act.

In developing the final rules, NFA believes it is important for the Commission to keep in mind the regulatory purposes behind these requirements. In particular, the Commission notes that Congress intended that these requirements "prevent undue influence by persons involved in trading or clearing activities over the substance of research reports that may be publicly disseminated, and to prevent pre-public dissemination of any material information in the possession of a person engaged in research and analysis, or of the research reports, to traders."[1] NFA agrees with these goals, but also believes that they must be further defined. In particular, NFA believes that the purpose behind preventing undue influence by trading and clearing personnel over the content of a research report is to ensure that research reports contain the actual views of the research analyst and do not contain information that is skewed or misleading in order to promote a particular derivative transaction. NFA also believes that the purpose behind preventing pre-public dissemination of material information to traders is to ensure that those traders do not provide that information to selected customers or trade ahead of their customers themselves. An important caveat to this provision, however, is that the research report contains **material** information, which

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[1] *See* 71 Fed. Reg. 70152 at 70154 (Nov.17, 2010).

NFA believes would be information that could have a price impact on the market for a particular product.

NFA also believes that in developing the final rules, the Commission should recognize that NFA's current regulatory framework has rules in place that address many of these concerns and can be used to augment any rules adopted by the Commission. For example, research reports that are disseminated to the public would be considered promotional material under NFA rules. Therefore, research reports are subject to all of NFA's promotional material requirements, including the requirement of Compliance Rule 2-29 that the report not be misleading or omit facts that make it misleading. In addition, NFA Compliance Rule 2-4 requires Members and Associates to observe high standards of commercial honor and just and equitable principles of trade in the conduct of their commodity futures business. If a Member or Associate gave preferable treatment to certain customers or used information obtained in a research report to their advantage over customers, this conduct would violate NFA Compliance Rule 2-4.

At the outset, NFA notes that the Commission's proposal, which is modeled after NASD Rule 2711[2] governing research reports involving investment banking services, includes a number of very specific prohibitions and requirements that may not be directly applicable to derivatives trading. NFA is concerned that the proposed rules may result in a number of unintended consequences that could be avoided by initially adopting more general requirements that the Commission can refine as it gains experience with this area. NFA recommends that the Commission consider taking the approach reflective in its proposed rulemaking related to Business Conduct Standards for Swap Dealer and Major Swap Participants with Counterparties (75 F.R. 80638, December 22, 2010), which in many areas sets forth broad general principles that Swap Dealers (SDs) and Major Swap Participants (MSPs) must adhere to in their dealings with counterparties.

NFA has taken this approach in regulating the use of research reports by Members registered as broker-dealers under Section 15(b)(11) of the Securities Exchange Act of 1934 with respect to security futures products (SFPs). NFA's Interpretive Notice entitled: *Obligations to Customers and Other Market Participants* prohibits these Members and their Associates from purposefully establishing, increasing, decreasing or liquidating a position in any SFP in anticipation of the issuance of a research report regarding the underlying security or a derivative based upon the underlying security. The Interpretive Notice recommends that Members

[2] *See* NASD (FINRA) Rule 2711 – Research Analysts and Research Reports.

develop and implement firewalls to isolate specific information within research and relevant departments to prevent the trading department from using the advance knowledge of the issuance of the research report. The Interpretive Notice also recognizes that supervisory procedures need to be adaptable to a firm's size and business practices and, therefore, it gives Members the flexibility to develop firewalls that are appropriate for their business models. Although NFA acknowledges that SFPs have traded on a limited basis, our regulatory oversight of these products has not found any issues with the use of research reports.

With regard to the Commission's specific proposal, NFA offers the following comments:

Small Firm Exception

The Commission specifically requests comment on whether the proposed rule should include an exception for small firms. NFA believes it is imperative that the Commission include this exception; otherwise the requirements may effectively prohibit the business model of a number of firms that provide an important service to the industry. In particular, a number of NFA Member IBs provide research and issue reports on agricultural products to their clients, often for hedging purposes. In many of these small firms, there is no distinction between individuals who engage in sales and trading and those who participate in research activities. Additionally, even if there are informal separations between these activities, these firms' employees often confer with each other in developing the firm's research.

Moreover, NFA believes that these small firms would never produce a research report that would have a price impact on the market for a particular product. In addition, any concern that the sales people in these firms would exert undue influence on the content of a research report in order to convince customers or potential customers to trade are adequately addressed by NFA's rules related to communications with the public.

NFA strongly encourages the Commission to adopt a small firm exception from these requirements. In adopting this exception, factors that the Commission may want to consider include a firm's gross annual revenue, number of APs, number of annual futures transactions, and the nature of the firm's customer base. As always, we offer our assistance to the Commission in gathering the necessary data and determining the appropriate parameters to afford a small firm exception to these requirements.

Definition of Research Report

As currently proposed, the term "research report" is broadly defined to mean "any written communication (including electronic) that includes an analysis of the price or market for any derivative, and that provides information reasonably sufficient upon which to base a decision to enter into a derivatives transaction." As discussed below, NFA has two concerns with the proposed definition of research report, and we encourage the Commission to revise the definition.

First, NFA believes the Commission needs to clarify that this definition applies to the price or market for a particular derivative and research must include information reasonably sufficient upon which to base a decision to enter into that particular derivatives transaction. In other words, the research has to contain sufficient detail to be a call to action to the customer. The current definition is overly broad and could be read to include a research report that discusses how weather conditions could affect the price of corn in general. NFA does not believe that either Congress or the Commission intended to include these general discussions.

Second, NFA notes that the proposed definition does not include an exclusion similar to the one in NASD Rule 2711(a)(9)(A) for general market commentary and the like. Although the specific exclusions in the NASD rule may not be directly applicable to the futures industry, the Commission should adopt exclusions for similar type commentary applicable to the futures industry.

Restriction on Relationship with Research Department

Commission Rule 1.71(c)(1)(i) prohibits non-research personnel from influencing the content of a research report. Although NFA agrees that non-research personnel should be prohibited from improperly influencing the content of a research report, NFA does not agree that non-research personnel should never have any input into the content of a report. In fact, NFA believes that this prohibition is contrary to the give and take that occurs between analysts, sales personnel and traders. As a result, the outright ban might actually impair the content of the research reports. In addition, NFA believes the other provisions in proposed rule 1.71(c)(1) provide adequate safeguards to ensure that non-research personnel do not improperly influence the content of the research report. Therefore, NFA recommends that the Commission delete this section from the final rule.

Restrictions on Communications

The Commission's proposal also provides that any written or oral communication by a research analyst to a current or prospective customer, or to any **employee** of the futures commission merchant or introducing broker, relating to any derivative must not omit any material fact or qualification that would cause the communication to be misleading to a reasonable person. Although NFA supports the Commission's requirement that any communication by the research analyst to a customer or prospective customer not omit any material fact or qualification that causes the communication to be misleading, NFA believes that extending this same requirement to communications with other employees is misplaced and unworkable.

Proposed Commission Rule 1.71(c)(2) appears to be drawn from NASD Rule 2711(c)(7)[3], which addresses concerns with research analysts' communications regarding the subject company of an investment banking transaction. The NASD Rule prohibits research analysts from engaging in solicitation or marketing efforts with respect to an investment banking transaction. The Rule also contains a provision similar in language to proposed Commission Rule 1.71(c)(2), which provides an exception to the overall prohibition and is designed to permit research analysts to educate investors and internal personnel about an investment banking services transaction, provided the communications are "fair, balanced and not misleading."[4]

The NASD provision applies to very specific communications by a research analyst on a particular investment banking services transaction. The language proposed by the Commission is far more sweeping and as written would apply to any type of communication by a research analyst that mentions a derivative. NFA is concerned that this language imposes an unachievable and unnecessary requirement on FCMs and IBs. It is unclear to NFA how an FCM or IB can ensure that all communications regarding a derivative, no matter how mundane, between its research analysts and other employees never omit a material fact. Moreover, NFA believes the requirement is unnecessary.

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[3] NASD Rule 2711(c)(7) provides that "any written or oral communication by a research analyst with a current or prospective customer or internal personnel related to an investment banking services transaction must be fair, balanced and not misleading, taking into consideration the overall context in which the communication is made."

[4] *See* FINRA Notice 05-34 SEC Approves Amendments to Rule 2711 to Prohibit Research Analysts from Participating in Road Show and from Communicating with Customers in the Presence of Investment Banking Personnel or Company Management about an Investment Banking Services Transaction.

The ultimate goal is to ensure that customers and prospective customers are not misled in communications on material issues. Therefore, the purpose of prohibiting a research analyst from providing other employees with misleading information is to presumably ensure that the information is not passed on to customers and prospective customers. Yet, the Commission has already built a strong protection in its proposed rules to deter this conduct by prohibiting research analysts' compensation to be based on the firm's trading business. By eliminating this potential conflict, a research analyst has little incentive to omit material information when communicating with other employees. In addition, even if the analyst did omit this information in internal communications, the Member FCM or IB and its Associates who communicate with the customer have an obligation to ensure that the information provided to customers is not misleading.

For these reasons, NFA encourages the Commission to delete reference to "employee" in proposed Rule 1.71(c)(2).

Disclosure Requirements

The Commission's proposed rule also requires that FCMs and IBs disclose in a research report and a research analyst disclose at a public appearance whether the research analyst maintains, from time to time, a financial interest in any derivative of a type that the research analyst follows. Although NFA agrees with the intent behind this disclosure requirement, NFA believes that the *time to time* language is too vague and recommends that the Commission require the disclosure if the research analyst maintains the financial interest at the time the research report is published or at the time of the public appearance.

NFA also encourages the Commission to clarify what is meant by the term "*of a type that the research analyst follows*" in conjunction with an analyst's disclosure obligations. NFA believes that the Commission should clarify that the "type" refers to four broad areas—interest rate swaps, credit swaps, equity swaps, and other commodity swaps.[5]

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[5] NFA notes that these four categories are consistent with the CFTC's own categorization of swaps in the context of swap dealer activity. See Further Definition of "Swap Dealer," "Security-Based Swap Dealer," "Major Swap Participant," "Major Security-Based Swap Participant" and "Eligible Contract Participant", 75 Fed. Reg. 80174, 80186 (Dec. 21, 2010).

Clearing Activities

Proposed Rule 1.17(d) sets forth a number of specific prohibitions on the relationship between FCMs and affiliated SDs and MSPs. Although NFA supports the Commission's ultimate goal of minimizing conflicts of interest that may arise between and among these entities with respect to clients, NFA is concerned that the specific prohibitions are too broad. Any rule adopted by the Commission should not negatively impact a firm's ability to share information about customers that is used to make credit determinations and ultimately measure the risk associated with the customer.

In closing, NFA reiterates its support of the Commission's ultimate goals with this rulemaking. NFA respectfully requests, however, that the Commission carefully consider the above noted comments, along with the comments of the industry, in developing the final rules in this area.

If you have any questions concerning this letter, please do not hesitate to contact the undersigned at (312) 781-1413 or tsexton@nfa.futures.org or Carol Wooding at (312) 781-1409 or cwooding@nfa.futures.org .

Respectfully submitted,

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(caw:Regulatory_conflicts of interest comment letter)