NFA Notice

9055 - NFA BYLAW 1101, COMPLIANCE RULES 2-9 AND 2-29: GUIDELINES RELATING TO THE REGISTRATION OF THIRD-PARTY TRADING SYSTEM DEVELOPERS AND THE RESPONSIBILITY OF NFA MEMBERS FOR PROMOTIONAL MATERIAL THAT PROMOTES THIRD-PARTY TRADING SYSTEM DEVELOPERS AND THEIR TRADING SYSTEMS (Board of Directors, August 19, 2004; effective January 10, 2005)

INTERPRETIVE NOTICE

In recent years, there has been a significant increase in the number of futures trading systems being marketed to the public. These trading systems typically are computerized programs that generate signals as to when to buy and sell commodity futures and options contracts.

A number of NFA Member firms offer trade execution services to customers who use these computerized trading systems, many of which are developed by third-party trading system developers ("third-party system developers"), who are neither NFA members nor registered with the CFTC. Typically, in these situations, the customer will execute a Letter of Direction that directs the Member to place trades for the customer in strict accordance with the signals generated by the trading system. In some cases, the Letter of Direction is more limited and includes instructions to follow only certain signals (e.g., signals in given contracts or signals that meet particular parameters). In almost all cases in which a Letter of Direction is used, the Member is not permitted to use any judgment when placing orders for the customer.

This notice is designed to provide guidance as to the circumstances which may give rise to liability on the part of the Member, under NFA Bylaw 1101, for providing execution services to users of computerized trading systems developed by non-Member third-party system developers. This notice will also discuss the factors that may cause a Member to be responsible, under NFA Compliance Rule 2-29, for promotional material which promotes these trading systems and the Member's supervisory obligations under NFA Compliance Rule 2-9.

REGISTRATION REQUIREMENTS FOR THIRD-PARTY SYSTEM DEVELOPERS

Section 1a (6) of the Commodity Exchange Act ("CEA") defines a CTA as any person who for compensation or profit, engages in the business of advising others, directly or through publications, writings, or electronic media, as to the value of or the advisability of trading commodity futures. Generally, Section 4m of the CEA requires individuals who fall within this definition to register with the CFTC. In March 2000, the CFTC adopted CFTC Rule 4.14(a)(9) to create an exemption from the CEA's registration requirements for CTAs that provide standardized advice by means of media such as newsletters, pre-recorded telephone hotlines, Internet web sites, and non-customized computer software. To qualify for the exemption, under Rule 4.14(a)(9)(i) a CTA may not direct client accounts. As defined by Commission Rule 4.10(f), direct, as used in the context of trading commodity interest accounts, refers to agreements whereby a person is authorized to cause transactions to be effected for a client's commodity interest account without the client's specific authorization." In a Commission Staff letter issued in May 2003, Commission Staff indicated that an agreement authorizing a person to direct a client's account - and, thus, requiring the person to be registered as a CTA - may be an informal agreement. The fact pattern addressed by the Commission's Staff letter involved a developer of a computerized trading system who was registered as an associated person ("AP") of an introducing broker ("IB"). The AP's activities on behalf of the IB consisted solely of soliciting clients to use his trading program. Such clients executed a "letter of direction" providing that the IB should execute trades for the clients' accounts and "follow [the trading program] signals as close as reasonably possible."

In analyzing the above fact pattern, Commission Staff concluded that, since the clients' contact with the AP/trading system developer included not only the trading program, but also the opening of a trading account that would be traded pursuant to a "letter of direction," there was an "informal arrangement", for

which the exemption provided under Rule 4.14(a)(9) was not intended. After specifically noting that the "whole of [the AP/trading system developer's] activities as an AP of the IB consisted of the solicitation of clients for the trading program, CFTC staff determined that registration as a CTA was required of either the IB or the AP. (See CFTC staff letter, No. 03-26, May 30, 2003, re Section 4m - Interpretation with regard to Commodity Trading Advisor Registration.)

Rule 4.14(a)(9)(ii) also provides that, to qualify for the exemption, a CTA may not provide "commodity trading advice based on, or tailored to, the commodity interest or cash market positions or other circumstances or characteristics of particular clients." So long as the CTA's advice is based on or tailored to such information, the CTA is required to register even if it gives the same advice to groups of similarly situated clients.

In determining whether advice is "based on or tailored to" within the meaning of 4.14 (a)(9)(ii), the context of the advice will be taken into account. For example, if the advice is provided in a book or a periodical, that factor may weigh against a finding that the CTA is providing advice "based on or tailored to" the characteristics of particular clients. On the other hand, if the advice is provided to a particular client in a face-to-face communication or over the telephone, that factor may weigh in favor of a finding that the CTA's advice is "based on or tailored to" that particular customer's characteristics, since such a context suggests that the CTA is being responsive to the client's individual needs.1

Whether a third-party system developer is required to be registered as a CTA still depends on the particular facts of each case. In some cases, the third-party system developer - or any third-party, for that matter - may be required to register as an IB, if it refers customers to an NFA Member and receives compensation for the referrals. Members who have questions concerning the application of Rule 4.14 are urged to seek advice from the CFTC.

Regardless of whether a third-party system developer is required to register as a CTA, the question sometimes arises whether the IBs involved must also register as CTAs. If the IB and the third-party system developer are operated as wholly independent entities and the IB has no authority to deviate from the third-party system developer's recommendations, generally the IB need not also register as a CTA. This is clearly the case where a customer independently selects a trading system and the IB does not solicit discretionary trading authority. However, if any of these factors change (e.g., the IB has authority to deviate from the trading system by selecting only some of the trades generated by the system), the IB may be required to register as a CTA, unless the IB is otherwise exempt because its activities related to placing trades based on the recommendations of the trading system are "solely in connection with its business as an IB."

NFA Bylaw 1101 provides, in pertinent part, that no Member may carry an account, accept an order or handle a transaction in commodity futures on behalf of any non-Member that is required to be registered as a CTA or in some other capacity. Therefore, if it appears that a third-party system developer, with whom an NFA Member does business, is required to be registered as a CTA or in some other capacity, the Member should request that the third-party system developer provide a letter from counsel stating the reasons why registration is not required.2 In the absence of such a letter, the Member should request that the third-party system developer apply for registration and NFA membership. If the third-party system developer fails or refuses to register and become an NFA Member, the Member should terminate its relationship with the third-party system developer to avoid liability under NFA Bylaw 1101.

A MEMBER'S RESPONSIBILITY FOR MISLEADING PROMOTIONAL MATERIAL WHICH PROMOTES A THIRD-PARTY SYSTEM DEVELOPER'S TRADING PROGRAM

NFA has encountered, with increasing frequency in recent years, misleading promotional material promoting trading systems developed by third-party system developers, who are not NFA Members, and for which an NFA Member provides trade execution services. Often this promotional material uses hypothetical or simulated results - which are trading results not achieved by an actual account - that are not

clearly identified as hypothetical and show impressive gains, when customers actually using the trading system have suffered substantial losses. In this and other contexts, both NFA and the Commission have brought numerous enforcement actions charging fraud in the use of such promotional material. Following are several examples of situations where Members may be held accountable under Compliance Rules 2-29 and 2-9 for misleading promotional material that promotes third-party trading system developers and their trading systems.

Direct Responsibility
If an NFA Member or its Affiliates prepare or distribute the promotional material, the Member will be responsible for its misleading content under NFA Compliance Rule 2-29, which prohibits a Member from using misleading or deceptive promotional material. Agency Responsibility

NFA's Business Conduct Committee has always recognized that each Member is responsible for the acts of its agents. This certainly applies to the preparation of advertising material. Thus, an NFA Member may be responsible, under NFA Compliance Rule 2-29, for misleading promotional material prepared and disseminated by a third-party trading system developer, whether or not the third-party trading system developer is an NFA Member or not, if there is an agency relationship between the NFA Member and the third-party trading system developer. (Of course, if the third-party trading system developer is also an NFA Member, it too would be responsible under NFA Compliance Rule 2-29 for the misleading promotional material that it prepared and distributed.)

In determining whether there is an agency relationship between the Member and the third-party system developer, which would trigger liability under NFA Compliance Rule 2-29, the central inquiry focuses on the nature of the business relationship between the parties and whether the parties have expressly or implicitly agreed that one may act for the other. As the CFTC has held, whether an agency relationship exists turns "on an overall assessment of the totality of the circumstances in each case." The more limited the contacts are between the third-party system developer and the NFA Member, the more likely it is that an agency relationship will not be found to exist between the parties.

If there is an agency relationship between the Member and the third-party system developer, then the Member has an affirmative duty, under NFA Compliance Rule 2-9, to supervise the activities of the third-party system developer/agent.

Supervisory Responsibility Under NFA Compliance Rule 2-9
Even where no agency relationship exists, a Member whose web site links to or otherwise refers customers to a third-party system developer or has a referral agreement with a third-party trading system developer should conduct a due diligence inquiry into the system developer's advertising practices with a view towards identifying and avoiding the misleading advertising practices described earlier, i.e., the use of exaggerated profit claims, and hypothetical or simulated results which are not clearly identified as hypothetical, or which show highly profitable performance when actual customers trading the system have sustained significant losses.

The fact that a Member creates a hyperlink from its web site or otherwise refers customers to a third-party system developer or has a referral agreement with a third-party system developer does not, in and of itself, make the Member firm accountable for the third-party system developer's web site or promotional material. Member firms should bear in mind, though, that their supervisory obligations under Rule 2-9 and Rule 2-29 require them to diligently supervise their employees and agents who are responsible for creating and maintaining hyperlinks to web sites of third-party system developers; or establishing referral agreements with third-party system developers. Members should consider whether appropriate supervisory procedures include periodic inquiries as to whether their employees and agents are conducting due diligence with respect to the third-party system developer's web site or advertising, and taking appropriate

steps if deficiencies are found in such web site or advertising. A Member's failure to supervise its employees and agents in this regard will constitute a violation of NFA Compliance Rule 2-9 on the part of the Member. Moreover, in these situations, Member firms should not seek to circumvent NFA's promotional material requirements by relying upon the unregistered status of the third-party trading system developer. 1 The Commission gives a number of examples, which illustrate the application of Rule 4.14(a)(9) in specific situations, in the Rule's publication in the Federal Register. (Federal Register: March 10, 2000 (Volume 65, Number 48, pages 12938-12943.)

2 Member firms may rely in good faith upon a copy of a letter from counsel. However, in some cases, a Member may have to perform additional due diligence to ascertain whether a third-party system developer is required to be registered.

3 See also NFA's interpretive notice entitled "NFA Compliance Rule 2-9: Supervisory Procedures for E-Mail and the Use of Web Sites" (Paragraph 9037).