

## V. Solicitation of Comments Concerning Amendments No. 2 and 4

Interested persons are invited to submit written data, views, and arguments concerning Amendments No. 2 and 4, including whether they are consistent with the Act. Comments may be submitted by any of the following methods:

### Electronic Comments

- Use the Commission's Internet comment form (<http://www.sec.gov/rules/sro.shtml>); or
- Send an e-mail to [rule-comments@sec.gov](mailto:rule-comments@sec.gov). Please include File Number SR-CBOE-2005-46 on the subject line.

### Paper Comments

- Send paper comments in triplicate to Jonathan G. Katz, Secretary, Securities and Exchange Commission, Station Place, 100 F Street, NE., Washington, DC 20549-9303.

All submissions should refer to File Number SR-CBOE-2005-46. This file number should be included on the subject line if e-mail is used. To help the Commission process and review your comments more efficiently, please use only one method. The Commission will post all comments on the Commission's Internet Web site (<http://www.sec.gov/rules/sro.shtml>). Copies of the submission, all subsequent amendments, all written statements with respect to the proposed rule change that are filed with the Commission, and all written communications relating to the proposed rule change between the Commission and any person, other than those that may be withheld from the public in accordance with the provisions of 5 U.S.C. 552, will be available for inspection and copying in the Commission's Public Reference Room. Copies of such filing also will be available for inspection and copying at the principal office of the Exchange. All comments received will be posted without change; the Commission does not edit personal identifying information from submissions. You should submit only information that you wish to make available publicly. All submissions should refer to File Number SR-CBOE-2005-46 and should be submitted on or before December 19, 2005.

## VI. Conclusion

For the foregoing reasons, the Commission finds that the proposed rule change, as amended, is consistent with the requirements of the Act and the rules and regulations thereunder.

*It is therefore ordered*, pursuant to Section 19(b)(2) of the Act,<sup>22</sup> that the proposed rule change (File No. SR-CBOE-2005-46), as amended, is approved, and that Amendments No. 2 and 4 thereto are approved on an accelerated basis.

For the Commission, by the Division of Market Regulation, pursuant to delegated authority.<sup>23</sup>

**Jonathan G. Katz,**

*Secretary.*

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## SECURITIES AND EXCHANGE COMMISSION

[Release No. 34-52808; File No. SR-NFA-2005-01]

### Self-Regulatory Organizations; National Futures Association; Notice of Filing and Immediate Effectiveness of Proposed Amendments to the Interpretive Notice to NFA Compliance Rule 2-9: Enhanced Supervisory Requirements.

November 18, 2005.

Pursuant to Section 19(b)(7) of the Securities Exchange Act of 1934 ("Exchange Act"),<sup>1</sup> and Rule 19b-7 under the Exchange Act,<sup>2</sup> notice is hereby given that on September 19, 2005, National Futures Association ("NFA") filed with the Securities and Exchange Commission ("SEC" or "Commission") the proposed rule change described in Items I, II, and III below, which Items have been prepared by NFA. The Commission is publishing this notice to solicit comments on the proposed rule change from interested persons.

NFA also submitted the proposed rule change to the Commodity Futures Trading Commission ("CFTC") on September 19, 2005 for approval. The CFTC has not yet given such approval.

#### I. Self-Regulatory Organization's Description of the Proposed Rule Change

Section 15A(k) of the Exchange Act<sup>3</sup> makes NFA a national securities association for the limited purpose of regulating the activities of Members who are registered as brokers or dealers in security futures products under Section 15(b)(11) of the Exchange Act.<sup>4</sup> NFA's Interpretive Notice entitled

"Compliance Rule 2-9: Enhanced Supervisory Requirements" ("Notice") applies to all Members who meet the criteria and could apply to Members registered under Section 15(b)(11).

The Notice requires a Member to adopt certain enhanced supervisory procedures ("Requirements") if its sales force includes a specified number of associated persons ("APs") who have worked at Disciplined Firms. NFA's Special Committee to Study Customer Protection Issues recently recommended changes to the Notice to resolve some emergent loopholes in the Requirements and further prevent abusive sales practices. The Board's changes:

- Automatically reimpose the Requirements on any firm that, having already completed a term under the Requirements, becomes subject to an NFA or CFTC enforcement action alleging sales practice abuses;
- Change the current obligation under the Requirements so that a firm may petition to have the Requirements lifted or modified after two years rather than automatically terminating;
- Add a provision designed to address issues related to firms avoiding the Requirements by making sham changes to entities and personnel when they become subject to the Requirements;
- Include listed principals who have previously worked for Disciplined Firms in the population used to calculate whether a Member firm has triggered an obligation to operate under the Requirements; and
- Exclude APs who worked at Disciplined Firms for less than sixty days more than five years ago from having to be counted for purposes of calculating whether a Member who hires such an individual is required to adopt the Requirements.

Below is the text of the proposed amendments to the Notice. Proposed new language is in *italics*; proposed deletions are in [brackets].

\* \* \* \* \*

#### Interpretive Notice

##### Compliance Rule 2-9: Enhanced Supervisory Requirements

Over the years, NFA's Board of Directors has adopted strict and effective rules to prohibit deceptive sales practices, and those rules have been vigorously enforced by NFA's Business Conduct Committees. The Board notes, however, that by their very nature, enforcement actions occur after the customer abuse has taken place. The Board recognizes that NFA's goal must be not only to punish such deception of customers through enforcement actions

<sup>22</sup> 15 U.S.C. 78s(b)(2).

<sup>23</sup> CFR 200.30-3(a)(12).

<sup>1</sup> 15 U.S.C. 78s(b)(7).

<sup>2</sup> 17 CFR 240.19b-7.

<sup>3</sup> 15 U.S.C. 78o-3(k).

<sup>4</sup> 15 U.S.C. 78o(b)(11).

but to prevent it, or minimize its likelihood, through fair and effective regulation.

One NFA rule designed to prevent abusive sales practices is NFA Compliance Rule 2-9. Subsection (a) of this rule places a continuing responsibility on every Member to supervise diligently its employees and agents in all aspects of their futures activities, including sales practices. Although NFA has not attempted to prescribe a set of supervisory procedures to be followed by all NFA Members, NFA's Board of Directors believes that Member firms which are identified as having a sales force that has received questionable training in sales practices should be required to adopt specific supervisory procedures designed to prevent sales practice abuse. Subsection (b) authorizes the Board of Directors to require Members, which meet certain criteria established by the Board, to adopt specific supervisory procedures designed to prevent abusive sales practices. Subsection (b) covers all activities regulated by NFA, including the off-exchange retail forex activities of Members subject to NFA Compliance Rule 2-36.

The Board believes that in order for the criteria used to identify firms subject to the enhanced supervisory requirements to be useful, those criteria must be specific, objective and readily measurable. The Board also believes that any supervisory requirements imposed on a Member must be designed to quickly identify potential problem areas so that the Member will be able to take corrective action before any customer abuse occurs. The purpose of this Interpretive Notice is to set forth the criteria established by the Board and the enhanced supervisory procedures which are required of firms meeting these criteria.

In developing the criteria, the Board concluded that it would be helpful to review Member firms which had been closed through enforcement actions taken by the CFTC or NFA for deceptive sales practices. The Board's purpose was to identify factors common to these Member firms and probative of their sales practice problems, which could be used to identify other Member firms with potential sales practice problems.

One factor identified by the Board as common to these firms and directly related to their sales practice problems is the employment history and training of their sales forces. For many of these Members, a significant portion of their sales force was previously employed and trained by one or more of the other Member firms closed for fraud. The Board believes that the employment

history of a Member's sales force *and principals* is a relevant factor to consider in identifying firms with potential sales practice problems. If a Member firm is closed by NFA or the CFTC for fraud related to widespread telemarketing or promotional material problems or a firm is closed by NASD or the SEC for fraud related to its sales practices regarding security futures products as defined in Section 1a(32) of the Commodity Exchange Act ("Act"), it is reasonable to conclude that the training and supervision of its sales force was wholly inadequate or inappropriate. It is also reasonable to conclude that an AP who received inadequate or inappropriate training and supervision may have learned improper sales tactics, which he will carry with him to his next job. Therefore, the Board believes that a Member firm employing such a sales force must have stringent supervision procedures in place in order to ensure that the improper training its APs have previously received does not taint their sales efforts on behalf of the Member.

The Board has determined that a Member will be required to adopt the specific supervisory procedures over its sales practice activities if:

- For firms with less than five APs, 2 or more of its APs have been employed by one or more Member firms which have been disciplined by NFA or the CFTC (or one or more firms disciplined by any securities industry self-regulatory organization or the SEC in matters involving security futures products) for sales practice fraud ("Disciplined Firms");
- For firms with at least 5 but less than 10 APs, 40 percent or more of its APs have been employed by one or more Disciplined Firms;
- For firms with at least 10 but less than 20 APs, four or more of its APs have been employed by one or more Disciplined Firms; or
- For firms with at least 20 APs, 20 percent or more of its APs have been employed by one or more Disciplined Firms.

*The Board also takes note that there have been instances in which Members and Associates have subverted the Board's purpose in imposing the enhanced supervisory procedures by closing a firm once it qualifies for those procedures and opening another firm or firms that have a mix of APs that does not meet the criteria for adopting the procedures. The new firms typically have APs who have worked for Disciplined Firms and who worked at the original firm, but they are redistributed so as to keep the AP mix below the threshold for becoming*

*subject to the enhanced supervisory procedures. This strategy deprives the very APs whose questionable training backgrounds gave rise to the creation of the enhanced supervisory procedures of the benefits of those procedures. Therefore, the Board has determined to further ensure that the benefits of the enhanced supervisory procedures are applied where they are of the greatest effect. Once a Member firm triggers the aforementioned criteria and becomes obligated to adopt the enhanced supervisory procedures, any other Members of which the principals of that Member firm are, or become, principals must also adopt the enhanced supervisory procedures or seek a waiver therefrom. In addition, for purposes of determining whether a Member will be required to adopt the enhanced supervisory procedures, principals of a firm, who are not also APs of that firm and who have been previously employed as an AP by one or more Disciplined Firms, shall be counted with the firm's APs in determining whether the firm meets the aforementioned criteria.*

Additionally, for purposes of determining whether a futures commission merchant ("FCM") Member firm meets this requirement, an FCM and its guaranteed introducing brokers ("GIBs") will be considered a single firm. Therefore, for FCMs with GIBs, the APs of its GIBs will be treated as APs of the FCM for determining whether the FCM meets the requirements. If the FCM Member firm meets the requirements, then the FCM and all its GIBs shall be required to adopt the supervisory procedures specified herein. Of course, individual FCMs or GIBs will be required to adopt the enhanced supervisory procedures provided the FCM or GIB meets the requirements on its own.

The Board recognizes that there is a group of APs who worked at Disciplined Firms for only a short period of time many years ago and who have not worked at any Disciplined Firm since. The Board's review of the employment and disciplinary histories of such individuals suggests that APs who served a very brief tenure with Disciplined Firms more than [10] five years in the past do not raise the same concerns regarding their previous supervision and training that are raised by APs who have worked at Disciplined Firms for longer periods or at a more recent point in time. Therefore, the Board has determined that APs who have been previously employed by Disciplined Firms for a cumulative total of less than 60 days and who, in addition, have not been employed by

any Disciplined Firm during the [10] 5 years preceding the determination of whether a Member firm is required to employ the enhanced supervisory procedures established in this Interpretive Notice shall not be counted for purposes of calculating whether the composition of a firm's sales force triggers enhanced supervisory requirements.

For purposes of this requirement, a Disciplined Firm is defined very narrowly to include those firms that meet the following three criteria:

1. the firm has been formally charged by either the CFTC or NFA with deceptive telemarketing practices or promotional material;
2. those charges have been resolved; and
3. the firm has been permanently barred from the industry as a result of those charges.

In addition, a Disciplined Firm shall be defined to include any broker-dealer that, in connection with sales practices involving the offer, purchase, or sale of any security futures product as defined in Section 1a (32) of the Act has been expelled from membership or participation in any securities industry self-regulatory organization or is subject to an order of the SEC revoking its registration as a broker-dealer.

Attached is a list of firms currently meeting the definition of a Disciplined Firm. Although this list is current as of the date of this Interpretive Notice, NFA [will provide] *provides* Members with an updated [lists] *list* [as necessary] *on its website at www.nfa.futures.org*.

Any Member firm meeting these criteria will be required either to operate pursuant to a guarantee agreement or maintain an adjusted net capital of at least \$250,000 for the entire period during which the Member is required to tape record its sales solicitations. Any Member opting to maintain the higher level of adjusted net capital would also be subject to the financial record-keeping and reporting requirements applicable to FCMs. Eligible guarantor futures commission merchants are those that meet the eligibility requirements for executing a Supplemental Guarantor Certification Statement pursuant to NFA Registration Rule 504(a)(2)(B). The Board believes that requiring these Members to operate pursuant to a guarantee agreement will likely improve the overall level of supervision at these firms.

Those Member firms meeting the criteria will be required to tape record all telephone conversations that occur between their APs and both existing and potential customers, including existing and potential retail forex customers of

Members subject to NFA Compliance Rule 2-36. The Board believes that tape recording these conversations provides these Members with the best opportunity to monitor closely the activities of their APs and also provides these Members with complete and immediate feedback on each AP's method of soliciting customers. *Members that are required to tape their conversations* [meeting the criteria must tape record these conversations for a period of two years and] must retain such tapes for a period of five years from the date each tape is created and the tapes shall be readily accessible during the first two years of the five-year period. In retaining the tape recorded conversations, Member firms must catalog the tapes by AP and date. Additionally, any Member firm meeting the criteria must require all its APs to maintain a daily log for sales solicitations which reflects at a minimum the identity of each customer or prospective customer the AP spoke with on each day. A Member firm must be able to promptly produce, upon request from NFA or the CFTC, all conversations relating to a specific AP, and only that AP, for a given date.

In addition, [for a period of two years,] those Member firms meeting the criteria will be required to file all promotional material, as defined in NFA Compliance Rule 2-29(i), with NFA at least 10 days prior to its first use.

Those Members meeting the criteria shall have written supervisory procedures that include the titles, registration status and locations of the firm's supervisory personnel as these relate to the firm's commodity futures business, retail forex business, and applicable securities laws and regulations for the trading of security futures products. Member firms shall also maintain on an internal record the names of all persons who are designated as supervisory personnel and the dates for which the designation is or was effective. Additionally, a Member meeting the criteria shall by the 30th day of the month following the end of each calendar quarter file with NFA's Compliance Department a report relating to the Member firm's compliance with the supervisory requirements contained herein. Member firms shall retain the internal record and report(s) for a period of five years, the first two years in an easily accessible place.

If an NFA Business Conduct Committee disciplinary proceeding or Commodity Futures Trading Commission enforcement proceeding has been filed against a Member firm required to adopt these enhanced

supervisory procedures, then the enhanced supervisory procedures will remain in effect for the applicable time period specified or until after the disciplinary or enforcement proceeding is closed and all appeals are completed or the time for appeal has passed without an appeal being filed or perfected, whichever occurs latest. *In addition, any Member that: has previously been required to adopt the enhanced supervisory procedures; has, in fact, fulfilled that requirement either by adopting the enhanced supervisory procedures for a prescribed period or by receiving a full or partial waiver from the enhanced supervisory procedures from the Telemarketing Procedures Waiver Committee; and subsequently becomes subject to a Commodity Futures Trading Commission or NFA enforcement or disciplinary proceeding alleging deceptive sales practices, shall, within 30 days of being served with notice of the action, initiate all of the enhanced supervisory procedures and may not seek a waiver therefrom. This obligation shall continue until after the disciplinary or enforcement proceeding is closed and all appeals are completed or the time for appeal has passed without an appeal being filed or perfected.* Member firms shall be required to retain tapes for the five-year period as specified above.

Any Member required to adopt these enhanced procedures may seek a waiver of the enhanced supervisory requirements *by filing a petition with the Telemarketing Procedures Waiver Committee within 30 days of the date of being notified by NFA that it is required to adopt the enhanced procedures.* NFA may grant such a waiver upon a satisfactory showing that the Member's current supervisory procedures provide effective supervision over its employees, including enabling the Member to identify potential problem areas before customer abuse occurs. Additionally, if a Member meets the criteria and trades security futures products, then the Member firm must also make a satisfactory showing that the Member's supervisory procedures ensure compliance with all applicable securities laws and regulations. *Should a Member fail to file a petition seeking a waiver within 30 days or should it file a petition that is denied by the Telemarketing Procedures Waiver Committee, either in whole or in part, the Member may not petition for a full or partial waiver again until at least two years have elapsed since the Member adopted the required enhanced procedures.*

Some of the factors that the three-member Waiver Committee may

consider in evaluating a waiver request include:

- The total number of APs sponsored by the Member;
- Number of branch offices and GIBs operated by the Member;
- The experience and background of the Member's supervisory personnel;
- The number of the Member's APs who had received training from firms which have been closed for fraud, the length of time those APs worked for those firms and the amount of time which has elapsed since those APs worked for the disciplined firms;
- The results of any previous NFA examinations; and
- The cost effectiveness of the taping requirement in light of the firm's net worth, operating income and related telemarketing expenses.

*Conditions that the Telemarketing Procedures Waiver Committee shall impose on any Member to which it grants a full or partial waiver include requirements that the firm: Notify NFA of any action charging the firm with a violation of Commodity Futures Trading Commission or Self Regulatory Organization ("SRO") regulations or rules; notify NFA of any customer complaint involving sales practices or promotional material; not change ownership; not have any material deficiencies noted during any SRO examination; not hire additional APs from Disciplined Firms; execute a written acknowledgement that the firm understands the conditions of the waiver; and may include any other conditions deemed by the Committee to be appropriate in furtherance of the effectiveness of the enhanced supervisory procedures. Violation of any of those conditions may serve as cause for the Telemarketing Procedures Waiver Committee to review and amend or revoke the waiver.*

A Member firm that does not comply with this Interpretive Notice will violate NFA Compliance Rule 2-9(b) and will be subject to disciplinary action.

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## II. Self-Regulatory Organization's Statement of the Purpose of, and Statutory Basis for, the Proposed Rule Change

In its filing with the Commission, NFA has prepared statements concerning the purpose of, and basis for, the proposed rule change, burdens on competition, and comments received from Members, participants, and others. The text of these statements may be examined at the places specified in Item IV below. NFA has prepared summaries, set forth in Sections A, B, and C below,

of the most significant aspects of such statements.

### A. Self-Regulatory Organization's Statement of the Purpose of, and Statutory Basis for, the Proposed Rule Change

#### 1. Purpose

a. Reimposing the Requirements on Members That Have Previously Satisfied an Obligation to Abide by Those Requirements and are Subsequently Charged in a CFTC or NFA Enforcement Action

In 1996, NFA's Board amended the Notice to provide that, if a Member that is currently subject to the Requirements becomes subject to a CFTC or NFA enforcement proceeding, the Requirements will remain in place for two years or until after the disciplinary or enforcement proceeding is concluded, whichever is longer. This provision does not, however, apply to Members that have already served full two-year tenures under the Requirements when one of those firms is subsequently charged in an enforcement action by the CFTC or NFA.

The practical effect of the current system is that some Members, with a number of APs from Disciplined Firms, that are charged by the CFTC or NFA in actions alleging fraudulent sales practices have a significant window of time during the pendency of the action to continue soliciting the public without any requirement to adopt additional prophylactic measures such as taping. Of course, in appropriate cases, prophylactic measures may be imposed as part of the ultimate resolution of the CFTC's or NFA's action, but it can take many months, or even years in cases that go through multiple layers of appeals, to resolve such actions.

There are at least three current NFA Members that served full terms under the Requirements and were subsequently charged in enforcement proceedings. It is worth noting that each of those firms still retains a sales force with histories at Disciplined Firms such that they would require the adoption of the Requirements but for the fact that they have already served the term of their obligation under the Notice. In fact, at one time, one of these firms actually featured its purported immunity from further taping requirements as an inducement in a recruitment advertisement contained in a South Florida newspaper.

A review of one firm's history illustrates the differences in the operations of the present system and the system being proposed. This firm has

been an introducing broker ("IB") NFA Member since August 1994. The NFA required the Member to adopt the Requirements from February 1995 through February 1997, when it was automatically discharged of the Requirements.

NFA then issued a Complaint alleging deceptive sales practices against the firm in April 1998. A settled Decision was issued at that same time which, among other penalties, required the firm to tape all solicitations from April 1998 through April 2000. NFA issued a second deceptive sales practice Complaint against the firm in January 2002, which was resolved in March 2003.

Because the firm had already fulfilled its obligation under the Notice from 1995 to 1997, it was not required under the current system to tape conversations with customers during the pendency of NFA's 2002 Complaint. This gave the firm a 14-month window to solicit the public without any obligation under the Notice to adopt the enhanced supervisory procedures—including taping. Incidentally, during this time, the firm continued to have a mix of APs that otherwise would have triggered the Requirements. The proposed amendments to the Notice would have required the firm to observe all of the Telemarketing Requirements, including taping all customer solicitations, from the time that the 2002 Complaint was initiated until that Complaint was completely resolved in March 2003.

The guiding principle in creating and refining the Requirements has always been to improve the overall level of supervision at those few Member firms which are likely to cause sales practice problems. When a firm that has already operated under the Requirements for two years because of the questionable backgrounds of its APs subsequently becomes subject to an NFA or CFTC enforcement action for sales practice abuses, there is a clear indication that the firm is, indeed, part of the group that is likely to cause sales practice problems and that it is prudent to require the firm to improve its level of supervision.

The proposed amendments to the Notice provide that any firm that has previously been required to abide by the Requirements but has fulfilled its obligation—either by abiding by the Requirements under the Notice as it currently stands or by successfully petitioning the Telemarketing Procedures Waiver Committee ("Waiver Committee") to have the Requirements lifted or modified—would again become subject to the Requirements during the

pendency and through appeals of a new CFTC or NFA enforcement action.

**b. Requiring Telemarketing Firms To Abide by the Telemarketing Requirements Until They are Granted a Complete or Partial Waiver by the Telemarketing Procedures Waiver Committee**

Currently, the obligation to abide by the enhanced procedures runs for two years, at which time it terminates automatically in most circumstances. The proposed amendments make it more likely that firms that continue to pose problems would remain subject to the Requirements for longer than the current two-year tenure provided for in the Notice. The modification puts the burden on Member Firms triggering the criteria to demonstrate that a waiver from the Requirements is warranted after two years rather than automatically discharging the obligation to abide by the Requirements once the two years has passed.

The amendments also provide that a Member firm has 30 days to seek a waiver from the Waiver Committee after it first employs an AP mix that would trigger the Requirements.<sup>5</sup> If the Waiver Committee denies the initial petition or no petition is filed, the firm would not be eligible to petition for a waiver again until it had served a full two years under the Requirements. Any waiver would be subject to conditions that, if violated, could subject the firm to revocation of the waiver by the Waiver Committee.<sup>6</sup> This additional component gives the Waiver Committee the flexibility to revisit the issue of whether a waiver is still warranted when there is a material change in the firm's organization or regulatory status.

<sup>5</sup> The Notice provides that some of the factors that the Waiver Committee may consider in evaluating a Member's waiver request include: The number of APs; the number of branch offices and GIBs; the experience and background of supervisory personnel; the number of APs who received training at Disciplined Firms, the time those APs worked for those firms and the amount of time which has passed since they worked for Disciplined Firms; The results of previous NFA examinations; and the cost effectiveness of taping.

<sup>6</sup> The conditions include requirements that the firm: Notify NFA of any action charging the firm with a violation of CFTC or SRO regulations or rules; Notify NFA of any customer complaint involving sales practices or promotional material; not change ownership; not have any material deficiencies noted during any SRO examination; not hire additional APs from Disciplined Firms; and execute a written acknowledgement that the firm understands the conditions of the waiver, and may include any other conditions deemed by the Waiver Committee to be appropriate in furtherance of the effectiveness of the enhanced supervisory procedures.

**c. Combating Sham Transactions and Including Principals Who Have Worked at Disciplined Firms in Calculating Whether a Member Firm has Qualified Under the Requirements**

The principals of several firms that have triggered the Requirements have avoided them by simply closing their firms and opening other firms that have a mix of APs that do not trigger an obligation to abide by the Requirements. The new firms typically have APs from the closed firm who have worked at Disciplined Firms, but their ratios to the overall AP population of the new firms are below the triggering point for imposing the Requirements.

For example, one firm, which had been an NFA Member IB since 1987, met the Requirements in March 2004. One particular individual had been the firm's principal and an AP of the firm since May 1987. The firm petitioned the Waiver Committee for a complete waiver from any obligation to abide by the Requirements. Although that Waiver Committee gave the firm a partial waiver by reducing the firm's required minimum adjusted net capital from \$250,000 to \$100,000, it did not waive the taping or other obligations.

Rather than having the firm abide by the Requirements, the individual simply withdrew the firm from NFA membership and created two new firms. Neither of those firms triggered the Requirements because the individual kept their AP populations below the triggering points by judiciously splitting APs from Disciplined Firms between the two firms. In addition, while the individual is a principal of both firms, he did not register as an AP of either of them. By so doing, he was able to avoid being personally counted as an AP from a Disciplined Firm for purposes of determining whether either firm had an AP population that triggered the Requirements.

The firm's use of a sham reorganization to avoid triggering the Requirements is not unique. NFA is aware of several other firms that have used similar tactics to avoid the Requirements.

NFA has developed a twofold approach to combat sham reorganizations and transfers designed to avoid the Requirements. First, once a firm has triggered the Requirements, then any other firms of which the principals of the qualifying firm are also principals would become subject to the Requirements.

Second, individuals who are listed principals, but who are not APs of the firm, will be included in the calculation for purposes of determining whether a

firm has triggered the Requirements if such individuals have previously worked as an AP at a Disciplined Firm. Principals who have not previously worked at a Disciplined Firm will not be included in the calculation. Otherwise, a firm could name "straw man" principals, thereby increasing the firm's overall calculation population and diluting the impact of the number of individuals who have worked at Disciplined Firms.

Counting non-AP principals who have been APs at Disciplined Firms in the past will cause eight current Member firms to trigger the Requirements. Collectively those firms have 12 individuals who are listed as principals but are not currently registered as APs of their respective firms. Those non-AP principals have worked as APs at 14 different Disciplined Firms in the past, and several of them have been personally named in CFTC and NFA actions. At least three other former Members would have been added during the past few years under the proposed amendments to the Notice, except that the CFTC took injunctive actions against them for sales practice violations and their NFA memberships were withdrawn.

Both of the successor firms resulting from the sham reorganization described above would trigger the Requirements under either of NFA's proposed amendments to the Notice. Since the principal of the original firm is also a principal of the two successor firms, that fact would automatically trigger the Requirements for those two firms. In addition, since the individual previously worked at a Disciplined Firm and is a non-AP principal of both successor firms, he would be included in the calculation of whether the AP mix at these two firms triggered the Requirements, which would result in a ratio that would trigger the Requirements for both successor firms.

**d. Individuals Who Had Brief Tenures at a Disciplined Firm a Number of Years Ago**

In 2003, the Board amended the calculation of APs that would trigger the Requirements to exclude APs who had worked at Disciplined Firms for less than 60 days more than 10 years ago. The proposed amendments to the Notice decrease the required time away from Disciplined Firms to five years while retaining the requirement that the individual must have worked a total of less than 60 days at Disciplined Firms.

Although their impact has been limited in terms of numbers, the 2003 modifications have had the desired effect of allowing a few firms that hire

APs who worked at Disciplined Firms for less than 60 days more than ten years ago to avoid triggering the Requirements. In fact, only two firms would have triggered the Requirements under the former method but were not so classified because of the 2003 modification, and neither has been subject of any regulatory action. In its latest review of the Requirements, NFA revisited the question of whether further modifications can be prudently made to decrease the potential burden on NFA's membership and the Waiver Committee. NFA studied data to examine the effect of keeping the less than sixty days at a Disciplined Firm requirement while reducing the time away from Disciplined Firms from ten to five years.

NFA's analysis showed that reducing the required period from 10 years to five years while maintaining the less 60 days cumulative tenure at Disciplined Firms requirement yielded a population that is of no more cause for concern than the present system. Approximately 1,280 individuals are exempted from being counted under the current system. Reducing the required length of time away from a Disciplined Firm to five years would add approximately 275 APs who would not have to be counted in determining if a firm triggered the Requirements. As was the case with the group that has been exempted under the current ten-year test, the number of additional APs who would be exempted under the proposed modification who have been subject to any kind of regulatory action is small.<sup>7</sup>

Based upon this data, NFA believes that the triggering criteria as currently set out in the Notice can be further refined to reduce the burden on the membership while still imposing supervisory enhancements on firms that pose a concern given the background of their APs and principals at Disciplined Firms. Not including APs and principals who served less than sixty cumulative days with Disciplined Firms more than five years ago in calculating whether a Member is subject to enhanced supervision would also serve the efficiency and fairness of the Waiver Committee's function by removing a few

non-problematic firms from the waiver process.

## 2. Statutory Basis

The rule change is authorized by, and consistent with, Section 15A(k) of the Exchange Act.<sup>8</sup>

### B. Self-Regulatory Organization's Statement on Burden on Competition

The rule change will not impose any burden on competition that is not necessary or appropriate in furtherance of the purposes of the Exchange Act and the Commodity Exchange Act.<sup>9</sup>

### C. Self-Regulatory Organization's Statement of Comments on the Proposed Rule Change Received From Members, Participants, or Others

NFA discussed the proposed rule change with its Special Committee to Study Customer Protection Issues, which voted to recommend the proposed rule change. NFA did not publish the proposed rule change to the membership for comment. NFA did not receive comment letters concerning the proposed rule change.

## III. Date of Effectiveness of the Proposed Rule Change and Timing for Commission Action

The proposed rule change is not effective because the CFTC has not approved the proposed rule change. Within 60 days of the date of effectiveness of the proposed rule change, the Commission, after consultation with the CFTC, may summarily abrogate the proposed rule change and require that the proposed rule change be refiled in accordance with the provisions of Section 19(b)(1) of the Exchange Act.<sup>10</sup>

## IV. Solicitation of Comments

### Electronic Comments

- Use the Commission's Internet comment form (<http://www.sec.gov/rules/sro.shtml>); or
- Send an e-mail to [rule-comments@sec.gov](mailto:rule-comments@sec.gov). Please include File No. SR-NFA-2005-01 on the subject line.

### Paper Comments

- Send paper comments in triplicate to Jonathan G. Katz, Secretary, Securities and Exchange Commission, 100 F Street NE., Washington, DC 20549-9303.

All submissions should refer to File No. SR-NFA-2005-01. This file number should be included on the subject line

if e-mail is used. To help the Commission process and review your comments more efficiently, please use only one method. The Commission will post all comments on the Commission's Internet Web site (<http://www.sec.gov/rules/sro.shtml>). Copies of the submission, all subsequent amendments, all written statements with respect to the proposed rule change that are filed with the Commission, and all written communications relating to the proposed rule change between the Commission and any person, other than those that may be withheld from the public in accordance with the provisions of 5 U.S.C. 552, will be available for inspection and copying in the Commission's Public Reference Room. Copies of such filing will also be available for inspection and copying at the principal office of the NFA. All comments received will be posted without change; the Commission does not edit personal identifying information from submissions. You should submit only information that you wish to make available publicly. All submissions should refer to File No. SR-NFA-2005-01 and should be submitted on or before December 19, 2005.

For the Commission, by the Division of Market Regulation, pursuant to delegated authority.<sup>11</sup>

Jonathan G. Katz,  
Secretary.

[FR Doc. E5-6558 Filed 11-25-05; 8:45 am]

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## SECURITIES AND EXCHANGE COMMISSION

[Release No. 34-52807; File No. SR-NSX-2005-06]

### Self-Regulatory Organizations; National Stock Exchange; Order Approving Proposed Rule Change, and Amendment Nos. 1 and 2 Thereto, To Amend the Exchange's Customer Priority Rule To Require Designated Dealers To Implement and Maintain Automated Compliance Systems

November 18, 2005.

## I. Introduction

On July 19, 2005, the National Stock Exchange<sup>SM</sup> ("NSX" or "Exchange") filed with the Securities and Exchange Commission ("Commission"), pursuant to Section 19(b)(1) of the Securities Exchange Act of 1934 ("Act")<sup>1</sup> and Rule

<sup>7</sup> Ten individuals who have been subject to actions by NFA or the CFTC are exempted from being included in the calculation of whether a Member has become a Telemarketing Firm under the Notice's current 10-year provision. The proposed modification to reduce the required time away from a Disciplined Firm to more than five years would exempt six additional individuals who have been subject to actions by NFA or the CFTC. All charges against those individuals have been resolved. None of the individuals has been permanently barred from the industry and none of them are currently registered.

<sup>8</sup> 15 U.S.C. 78o-3(k).

<sup>9</sup> 7 U.S.C. 1.

<sup>10</sup> 15 U.S.C. 78s(b)(1).

<sup>11</sup> 17 CFR 200.30-3(a)(75).

<sup>1</sup> 15 U.S.C. 78s(b)(1).