CFTC Letter No. 00-56

April 13, 2000

Interpretation

Robert K. Wilmouth
President
National Futures Association
200 West Madison Street
Chicago, IL 60606-3447

Re: Use of Exchange Disciplinary Actions as "Other Good Cause" to Affect Floor Broker/Floor Trader Registration

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Dear Mr. Wilmouth:

I. INTRODUCTION AND BACKGROUND

In July 1997, the Commission issued a Notice and Order authorizing the National Futures Association ("NFA") to grant or to maintain, either with or without conditions or restrictions, floor broker ("FB") or floor trader ("FT") registration where NFA previously would have forwarded the case to the Commission for review of disciplinary history.[1] By letter dated December 4, 1997 ("Guidance Letter"), the Commission provided further direction on how the Commission expected NFA to exercise its delegated power and to ensure that NFA exercised its delegated power in a manner consistent with Commission precedent.

The Commission has determined to revise the Guidance Letter. Specifically, the Commission is revising the portion of the Guidance Letter that addresses the use of exchange disciplinary actions as "other good cause" to affect FB and FT registrations. The Commission has made this determination following its own reconsideration of the issue and at the urging of industry members.[2]

The Guidance Letter pointed out that, in exercising its delegated authority, NFA must apply all of the provisions of Sections 8a(2) and (3) of the Commodity Exchange Act ("Act").[3] In particular, Section 8a(3)(M) of the Act authorizes the Commission to refuse to register or to register conditionally any person if it is found, after opportunity for hearing, that there is other good cause for statutory disqualification from registration beyond the specifically listed grounds in Sections 8a(2) and 8a(3) of the Act. The Commission held in *In the Matter of Clark* that statutory disqualification under the "other good cause" provision of Section 8a(3)(M) may arise on the basis of, among other things, a pattern of exchange disciplinary actions alleging serious rule violations that result in significant sanctions, and that it is immaterial whether the sanctions

imposed resulted from a fully-adjudicated disciplinary action or an action that was taken following a settlement.[4]

The Guidance Letter recommended the application of the provisions of Commission Rule 1.63[5] as criteria to aid in assessing the impact of an FB or FT applicant's or registrant's previous disciplinary history on the person's fitness to be registered, with the exception that NFA should be acting based on disciplinary history from the previous five years, rather than the three years provided for in Rule 1.63.[6] The Guidance Letter also noted that NFA should consider disciplinary actions taken not only by futures industry SROs but also those taken by SROs as defined in Section 3(a)(26) of the Securities Exchange Act of 1934 ("1934 Act"), including settled disciplinary actions.

II. REVISED GUIDANCE

As stated above, the Commission has determined to revise the Guidance Letter. From this point forward, NFA should cease using Rule 1.63 as the basis to evaluate the impact of an FB or FT applicant's or registrant's disciplinary history on his or her fitness to be registered. Instead, as *Clark* stated, when reviewing disciplinary history to assess the fitness to be registered of an FB, FT, or applicant in either category, a pattern of exchange disciplinary actions alleging serious rule violations that result in significant sanctions will trigger the "other good cause" provision of Section 8a(3)(M). The "pattern" should consist of at least two final exchange disciplinary actions, whether settled or adjudicated.

NFA also should consider initiating proceedings to affect the registration of the FB or FT, even if there is only a single exchange action against the FB or FT, if the exchange action was based on allegations of particularly egregious misconduct or involved numerous instances of misconduct occurring over a long period of time. If, however, a proceeding is initiated based on a single exchange action that was disposed of by settlement, NFA may have to prove up the underlying misconduct. Furthermore, traditional principles of collateral estoppel apply to adjudicated actions, whether they are being considered individually or as part of a pattern.[7]

As provided by the Guidance Letter, "exchange disciplinary actions" would continue to include disciplinary actions taken by both futures industry SROs and SROs as defined in Section 3(a)(26) of the 1934 Exchange Act. Furthermore, NFA should review an applicant's or registrant's disciplinary history for the past five years.[8] At least one of the actions forming the pattern, however, must have become final after *Clark* was decided by the Commission on April 22, 1997. Finally, "serious rule violations" consist of, or are substantially related to, charges of fraud, customer abuse, other illicit trading practices, or the obstruction of an exchange investigation.

Congress, the courts and the Commission have indicated the importance of considering an applicant's history of exchange disciplinary actions in assessing that person's fitness to register.[9] Furthermore, NFA's review of exchange disciplinary actions within the context of the registration process should not simply mirror the disciplinary actions undertaken by the

exchanges. The two processes are separate matters that involve separate considerations. As part of their ongoing self-regulatory obligations, exchanges must take disciplinary action[10] and such disciplinary matters necessarily focus on the specific misconduct that forms the allegation. In a statutory disqualification action, however, NFA must determine whether the disciplinary history of an FB, FT or applicant over the preceding five years should impact his or her registration. Additionally, NFA possesses industry-wide perspective and responsibilities. As such, NFA, rather than an individual exchange, should decide registration status issues, since those issues affect an individual's status within the industry as a whole, well beyond the jurisdiction of a particular exchange.

The Commission also wants to clarify to the fullest extent possible that its power to delegate the authority to deny or condition the registration of an FB, FT, or an applicant for registration in either category permits exchanges to disclose to NFA all evidence underlying exchange disciplinary actions, notwithstanding the language of Section 8c(a)(2) of the Act.[11] The Commission's power to delegate stems from Section 8a(10) of the Act, which permits delegation of registration functions, including statutory disqualification actions, to any person in accordance with rules adopted by such person and submitted to the Commission for approval or for review under Section 17(j) of the Act, "notwithstanding any other provision of law." Certainly, Section 8c(a)(2) qualifies as "any other provision of law." Furthermore, the effective discharge of the delegated function requires NFA to have access to the exchange evidence. Thus, the exercise of the delegated authority pursuant to Section 8a(10) permits the exchanges to disclose all evidence underlying disciplinary actions to NFA.[12]

This letter supersedes the Guidance Letter to the extent discussed above. In all other aspects, the Guidance Letter and other guidance provided by the Commission or its staff remain in effect. Therefore, NFA should continue to follow Commission precedent when selecting conditions or restrictions to be imposed. For example, NFA should impose a dual trading ban where customer abuse is involved and any conditions or restrictions imposed should be for a two-year period. Furthermore, NFA should require sponsorship for conditioned FBs or FTs when their disciplinary offenses involve noncompetitive trading and fraud.

Nothing in the Notice and Order or this letter affects the Commission's authority to review the granting of a registration application by NFA in the performance of Commission registration functions, including review of the sufficiency of conditions or restrictions imposed by NFA, to review the determination by NFA not to take action to affect an existing registration, or to take its own action to address a statutory disqualification. Moreover, the Commission Order contemplates that to allow for appropriate Commission oversight of NFA's exercise of this delegated authority, NFA will provide for the Commission's review quarterly schedules of all applicants cleared for registration and all registrants whose registrations are maintained without adverse action by NFA's Registration, Compliance, Legal Committee despite potential statutory disqualifications.

The Commission will continue to monitor NFA activities through periodic rule enforcement reviews, and NFA remains subject to the present requirement that it monitor compliance with the conditions and restrictions imposed on conditioned and restricted registrants.

Sincerely,

Jean A.
Webb
Secretary
of the
Commission

MWL/ml

cc: Daniel J. Roth
Executive Vice President – Chief Compliance Officer
National Futures Association

Daniel A. Driscoll
Executive Vice President – Chief Operating Officer
National Futures Association

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1 Registration Actions by National Futures Association With Respect to Floor Brokers, Floor Traders and Applicants for Registration in Either Category, 62 Fed. Reg. 36050 (July 3, 1997).

2 *See* letters submitted by James Bowe, former president of the New York Board of Trade ("NYBOT"), dated October 13, 1999, Christopher Bowen, general counsel of the New York Mercantile Exchange ("NYMEX"), dated October 18, 1999, and the Joint Compliance Committee ("JCC"), dated February 2, 2000. The JCC consists of senior compliance officials from all domestic futures exchanges and the NFA (*i.e.*, the domestic self-regulatory organizations ("SROs")). In addition, staff from the Contract Markets Section of the Commission's Division of Trading and Markets attend the JCC meetings as observers. The JCC was established to aid in the development of improved compliance systems through joint efforts and information-sharing among the SROs. Commission staff have also discussed this issue with SRO staff.

3 7 U.S.C. §§ 12a(2) and (3) (1994).

4 *In the Matter of Clark*, [1996-1998 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 27,032 (CFTC April 22, 1997), *aff'd sub nom., Clark v. Commodity Futures Trading Commission*, No. 97-4228 (2d Cir. June 4, 1999) (unpublished).

5 Commission rules referred to in this letter are found at 17 C.F.R. Ch. 1 (1999).

6 Rule 1.63 provides, among other things, that a person is ineligible from serving on SRO disciplinary committees, arbitration panels, oversight panels or governing boards if that person, *inter alia*, entered into a settlement agreement within the past three years in which any of the findings or, in the absence of such findings, any of the acts charged included a disciplinary offense.

Rule 1.63(a)(6) defines a "disciplinary offense" to include:

(i) any violation of the rules of an SRO except those rules related to (A) decorum or attire, (B) financial requirements, or (C) reporting or record-keeping unless resulting in fines aggregating more than $5,000 within any calendar year; (ii) any rule violation described in subparagraphs (A) through (C) above that involves fraud, deceit or conversion or results in a suspension or expulsion; (iii) any violation of the Act or the regulations promulgated thereunder; or (iv) any failure to exercise supervisory responsibility with respect to an act described in paragraphs (i) through (iii) above when such failure is itself a violation of either the rules of an SRO, the Act or the regulations promulgated thereunder.

7 *Clark* at 44,929.

8 The Commission generally looked at a five-year period of disciplinary history. On occasion, however, the Commission examined a longer period of an applicant's or registrant's disciplinary history. For example, the Commission revoked the registration of one FB on the basis of exchange disciplinary cases that extended back six years, *see Clark*, 2 Comm. Fut. L. Rep. (CCH) ¶27,032, and denied an application for registration as an FT on the basis of exchange disciplinary cases that extended back seven years, *see In the Matter of Castellano*, [1987–1990 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 24,360 (ALJ Nov. 23, 1988), *summarily aff'd* (CFTC May 29, 1990), *reh. denied* [1990-1992 Transfer Binder] Comm. Fut. L. Rep. ¶ 24,870 (CFTC June 26, 1990), *aff'd sub nom. Castellano v. CFTC*, Docket No. 90-2298 (7th Cir. Nov. 20, 1991).

9 Letter dated July 14, 1995, from Mary L. Schapiro to R. Patrick Thompson, President, New York Mercantile Exchange (unpublished). *See also, Castellano, supra* note 8.

10 *See* Rule 1.51(a)(7).

11 Section 8c(a)(2) states, in relevant part, that "[A]n exchange…shall not disclose the evidence therefor, except to the person who is suspended, expelled, disciplined, or denied access, and to the Commission."

12 Of course, the Commission could request records from the exchange and forward them to NFA. The Commission believes that this is an unnecessary administrative process and that NFA should obtain the records it needs to carry out the delegated function of conducting disciplinary history reviews directly from the exchanges. In this context and pursuant to Commission orders authorizing NFA to institute adverse registration actions, NFA should be viewed as standing in the shoes of the Commission.