

National Futures Association Proposes Overhaul of its Member Requirements for the Supervision of Branch Offices and Guaranteed Introducing Brokers

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The National Futures Association (NFA) has proposed updated guidance (the Proposed Guidance) for all of its member firms—including futures commission merchants (FCMs), retail foreign exchange dealers (RFEDs), introducing brokers, commodity pool operators and commodity trading advisors—related to those firms' supervision of their branch offices and/or relationships with their guaranteed introducing brokers (G-IBs).¹ The Proposed Guidance will supersede and replace existing interpretive guidance associated with NFA Rule 2-9 for the supervision of branch offices and G-IBs.²

NFA submitted the Proposed Guidance to the US Commodity Futures Trading Commission (CFTC) on May 21, 2019, subject to a 10-day review schedule.³ The Proposed Guidance is expected to take effect later this year.

By proposing the amendments in the Proposed Guidance, NFA is seeking to update the supervision and surveillance requirements that member firms must comply with in order to reflect advances in electronic trading, electronic communications and other technologies in the futures and derivatives markets. Instead of making minor changes to NFA's existing guidance, NFA seeks to delete and substantially restructure the existing interpretive guidance in order to better organize the detailed requirements under the following four main categories:

- Due Diligence;
- Written Policies and Procedures for Routine Supervision and Surveillance;

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- On-Site Inspection; and
 - Training.⁴

Due Diligence.

For advance due diligence review of potential branches and G-IBs, members will be required to consider the nature of the business to be conducted in the location and the background and employment history of all personnel to ensure they are qualified, as well as to ensure that at least one person will be able to track CFTC and NFA regulatory developments. As a result of its due diligence, the member should confirm that it wants to establish the branch office or G-IB relationship and determine the scope of the supervisory oversight it should apply on an ongoing basis.

Written Policies and Procedures for Routine Supervision and Surveillance.

With respect to routine supervision and surveillance, the Proposed Guidance provides that member firms must continue to adopt written policies and procedures that, among other things, set forth the manner and frequency in which they will exercise routine supervision and surveillance of their branch offices and G-IBs. Although the Proposed Guidance endeavors to provide members with flexibility in designing their specific supervisory programs in light of differences in "the size and complexity of [m]ember firm operations," the Proposed Guidance sets forth minimum standards for all members.

A member firm's policies and procedures must expressly note when it will notify NFA and/or other "appropriate regulators" of "significant findings" including, but not limited to, fraud or customer harm. Qualified personnel must perform the routine surveillance and inspections, although third-party vendors may be retained to assist in such activities; however, in such instance the member must perform due diligence to confirm the third-party vendor is qualified.

Several of the minimum standards set forth in the Proposed Guidance have carried over from existing interpretive guidance associated with NFA Rule 2-9, such as guidance regarding registration, hiring, promotional material, sales practices, customer information and risk disclosure, handling of customer funds, customer order procedures, account activity, discretionary accounts, proprietary accounts, bunched orders and customer complaints. Since the last update to NFA's guidance was adopted in 2000, there are a number of new requirements enumerated in the Proposed Guidance that reference recent NFA rules such as requirements related to the development of anti-money laundering programs and information system security programs.⁵

On-site Inspections.

Like before, the Proposed Guidance includes a general requirement that members conduct annual on-site inspections of branch offices or G-IBs that are meant to be more comprehensive and detailed. However, the Proposed Guidance now includes two exceptions to the general requirement.

The first exception to the annual on-site inspection requirement allows members to perform a prompt inspection if they become aware of any indicia of irregularities or misconduct involving the branch office or G-IB.

The second exception to the requirement allows a member to use a risk-based approach to conduct

inspections every other calendar year instead of annually when the member: (1) makes a written determination regarding the appropriateness of conducting inspections every other year; and (2) has the capabilities to conduct remote inspections in the off years. The member's written determination when taking the risk-based approach should consider the following factors with respect to the branch office or G-IB: (1) the amount of revenue generated by the office or G-IB; (2) the type of business conducted in the branch office or G-IB; (3) whether the branch office or G-IB solicits new clients versus services old clients; (4) the number of associated persons in the branch office or G-IB; (5) the number and nature of complaints for that branch office or G-IB; (6) the previous training experience as well as the disciplinary history of the branch office or G-IB and its personnel; (7) if the G-IB has more than one branch; (8) the frequency and nature of problems and concerns that arise through routine supervision and surveillance; and (9) whether the branch office or G-IB directly accepts customer funds.

Training.

As before, the Proposed Guidance requires that member firms have qualified individuals train their branch office and G-IB personnel on applicable industry rules and regulations. The Proposed Guidance also requires certain of their associated persons be trained to properly solicit and handle customer accounts. Similarly, the Proposed Guidance requires that members ensure their associated persons to satisfy ethics requirements consistent with NFA Interpretive Notice 9051.⁶ Lastly, the Proposed Guidance provides that the formality of the training program will depend on the size of the firm and the nature of its business.

NFA members should take note that, like the existing guidance regarding supervision of branch offices and G-IBs, the Proposed Guidance applies to all members (although provisions related to G-IBs are solely meaningful to FCMs and RFEDs). Accordingly, all members must review the Proposed Guidance to assess which provisions might apply to them and to revise their policies and procedures to reflect new requirements. NFA has made clear that a failure to adhere to the requirements in the Proposed Guidance will constitute a failure to supervise violation (*i.e.*, a violation of NFA Compliance Rule 2-9).

Moreover, all members should be aware of NFA's expectation that they will escalate to it "and/or" other regulators "significant findings" identified during routine supervision or annual inspections. These might include findings related to fraud or customer harm, but are not expressly limited. When revising their policies and procedures, members should not solely cut and paste NFA's requirements, but adapt them specifically to their own business operations. Moreover, all policies and procedures should be periodically reviewed and updated to reflect amended regulatory requirements and changed business operations.

1 NFA, Interpretive Notice *Compliance Rule 2-9: Supervision of Branch Offices and Guaranteed IBs* (May 21, 2019), available at: <https://www.nfa.futures.org/news/PDF/CFTC/Interp-Notice-CR%202-9-Supervision-Branch-Offices-GIBs-052119.pdf>.

2 NFA Interpretive Notice 9019 - *Compliance Rule 2-9 Supervision of Branch Offices and Guaranteed IBs* (July 24, 2000), available at: <https://www.nfa.futures.org/rulebook/rules.aspx?Section=9&RuleID=9019>.

3 NFA Letter to Christopher J. Kirkpatrick, Secretary of the CFTC (May 21, 2019) ["NFA Letter"]. The CFTC's 10-day review process is found in Section 17(j) of the Commodity Exchange Act.

4 See NFA Letter at 17-19.

5 See NFA Letter at 6 and 8.

6 NFA Interpretive Notice, 9051 - *NFA Compliance Rules 2-9 and 2-36: Ethics Training Requirements* (July 1, 2003), available

at: <https://www.nfa.futures.org/rulebook/rules.aspx?RuleID=9051&Section=9>. In October 2001, the CFTC issued a Statement of Acceptable Practices ("Statement") for ethics training. This replaces the Commission's prescriptive ethics training rule and allows flexibility in the format, frequency and providers of ethics training, permitting each firm to tailor its training program to better suit its own operations. By the same token, it shifted the responsibility to each firm to adopt and implement an appropriate ethics training scheme.

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