

**Review of the Disciplinary Program
of
National Futures Association**

Commodity Futures Trading Commission
Division of Clearing and Intermediary Oversight

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I. INTRODUCTION

This is a report on a review by the Division of Clearing and Intermediary Oversight ("Division")¹ of National Futures Association's ("NFA") disciplinary program ("Program"). The purpose of this review was to examine NFA's implementation and operation of the Program. The Division's review focused on: 1) the handling of potential violations of NFA rules by NFA members discovered by NFA's Compliance Department; 2) the investigation of those potential violations that may warrant disciplinary action, including coordination between the Compliance Department and Enforcement Attorneys within NFA's Legal Department; and 3) the formal NFA disciplinary process, including the handling of complaints by NFA's Business Conduct Committee ("BCC"), hearings before panels of members of NFA's Hearing Committee ("Hearing Panels"), sanctions imposed upon members found to have violated NFA rules, settlements, and appeals.

II. SUMMARY OF FINDINGS AND RECOMMENDATIONS

The Division found that NFA's Program is generally well-designed and is highly successful in obtaining judgments against those NFA members that NFA staff have determined have committed violations meriting discipline. The program is executed by well-trained, experienced staff. The Division's interviews made clear that NFA Enforcement and Compliance staff are clearly dedicated to their work. NFA's dedication to improving its program was demonstrated by the 1997 Report of the Legal/Compliance Workflow Team and the 1998 Report of the Disciplinary Proceedings Innovation Team. These reports resulted in organizational and procedural changes that have clearly improved NFA's program.

The Division's review also revealed several areas that provide further opportunities for improvement in NFA's Program, and the Division makes the following four recommendations:

Recommendation No. 1: NFA should obtain written evidence that violations discovered by NFA during audits and other compliance reviews have been corrected by the member.

Many violations found by NFA during its audits and other compliance reviews of members may warrant remediation rather than formal discipline. These violations may arise from unintentional ignorance or misunderstanding of

¹ This review was conducted by the Audit and Financial Review section of the former Division of Trading and Markets. As a result of the Commission's reorganization of July 1, 2002, the Audit and Financial Review Section is part of the new Division of Clearing and Intermediary Oversight.

NFA rules, a deficiently designed system of internal controls, or a minor degree of carelessness. In such cases, helping the member achieve compliance by pointing out the deficiencies and permitting the member an opportunity to fix them is frequently the most appropriate course of action.

It is important that, in each such case, NFA verifies that the deficiencies are, in fact, corrected. NFA's usual policy with respect to deficiencies found in an audit is to discuss the problems with the member during the course of the audit and in the exit interview and to obtain oral representations from member personnel regarding how the deficiencies will be addressed. "Generally, a written response to the audit report [is not] required."² Thus, under NFA's current procedures, there is often no written evidence that the problems have, in fact, been resolved.

Moreover, a problem that has not been resolved may remain (and recur) for an extended period of time. Based on NFA's normal audit cycle, many members are audited only once every three to five years.

The Division recommends that NFA require written responses addressing each of the compliance problems included in an audit report, detailing the steps taken to resolve the problem and representing that the problems have, in fact, been resolved. In the case of more serious compliance problems, NFA should verify the fact that the problem has been resolved. For example, NFA might use on-site or, where appropriate and effective, remote spot-checks conducted some months after the audit.

Recommendation No. 2: NFA should develop internal guidelines for progressive action to be taken when repetitive problems are identified.

The Division examined NFA's handling of repetitive problems – problems that were found after similar problems had been brought to a member's attention in a prior audit. Division staff compared two consecutive audits for each of a sample of members, and analyzed the steps that NFA took where a problem found in the second audit was similar to a problem that was found in the first audit.

In a large number of cases involving repetitive problems, the action NFA took upon discovering that the problem had recurred was the same – i.e., NFA asked for, and accepted, another oral representation that the problem would be addressed. This procedure does not account for the consideration that NFA's

² *NFA Regulatory Requirements for FCMs, IBs, CPOs and CTAs* (December, 2001). The Division's interviews with Compliance staff and review of audits in the sample confirmed that this is NFA's general policy, although there are situations in which NFA does require a written response.

action in the prior instance was ineffective in causing the member to achieve compliance.

The Division recommends that NFA develop guidelines that provide for progressive action to address problems that recur.³ For example, a repetitive violation may well make a compelling case for the use of a post-audit spot check to ensure that the promised corrective steps have been taken and were effective. An oral representation that the problem will be corrected should not be the sole means for addressing a repetitive problem.

Recommendation No. 3: NFA staff should improve documentation of the reasons for their decision to forego taking disciplinary action in cases of repetitive serious violations.

While the Division's review did not focus on evaluating NFA staff's decisions to take or forego disciplinary action, in a number of cases that were reviewed involving repetitive sales practice violations, the lack of referral to the BCC seemed particularly noteworthy. The reasons for these decisions were not included in NFA's records. Division staff discussed these cases with NFA staff, who explained their reasons for deciding not to recommend BCC action in those cases. Their analysis was based on factors such as the ability to make a case given available evidence and witnesses, and whether the violations were sufficiently egregious to warrant prosecution. The Division does not question the appropriateness of NFA's use of prosecutorial discretion in reaching these decisions. The Division does recommend that NFA improve its documentation of its rationale for such decisions so that: 1) NFA can use this information in its future dealings with the member; 2) NFA can build an understanding of any "loopholes" in, or other improvements needed to its rules; and 3) the Division may have sufficient information to be able to fulfill its oversight responsibilities.

Recommendation No. 4: NFA staff should improve documentation of their rationale for making recommendations on sanctions.

In interviews, NFA staff involved in the disciplinary process said that they consider several factors in determining the type of sanctions to recommend to the BCC or Hearing Panel. These include the factors discussed in the CFTC policy guidelines for SRO sanctions,⁴ such as the seriousness of the offense, the disposition of similar prior cases, customer losses, and the member's disciplinary

³ There may, of course, be situations where repetitive problems do not warrant more serious action—for example, in situations where a certain error rate is inevitable. However, these situations should be the exception, not the rule.

⁴ "CFTC Policy Statement Relating to the Commission's Authority to Impose Civil Monetary Penalties and Futures Self-Regulatory Organizations' Authority to Impose Sanctions; Penalty Guidelines," Comm. Fut. L. Rep. (CCH) ¶26,265 (November 1994). Commission Regulation 1.3(ee) defines "self-regulatory organization" to include registered futures associations.

history, including actions by NFA, CFTC, other SROs, and other regulatory agencies. NFA staff indicated that their recommendations are formed after a full and robust internal discussion. Staff also indicated that the rationale for the recommendation was generally presented as part of oral argument during a hearing, or in the memo to the BCC or Hearing Panel recommending acceptance of a settlement offer.

The Division reviewed memoranda from NFA staff transmitting their recommendations concerning settlement proposals, as well as transcripts of hearings before Hearing Panels. This review revealed that the rationale for acceptance of a settlement offer was generally presented in one or two sentences and provided very little explanation of the reasons for recommending that the specific sanctions be imposed. The lack of documentation of the rationale makes it more difficult for NFA staff to form a permanent institutional history of the factors that warrant specific sanctions, as well as more difficult for the Division to obtain evidence that the proper factors are, in fact, being considered.

III. BACKGROUND

A. Regulatory Basis for NFA's Program

NFA has been designated as a "registered futures association" pursuant to Section 17(p) of the Commodity Exchange Act ("CEA").⁵ NFA is required by Section 17(b)(8) of the CEA to adopt rules to discipline its members for rule violations and to establish a fair and orderly disciplinary procedure that meets the criteria set forth in Section 17(b)(9) of the CEA. Commission Regulation 170.6 provides that, in disciplining its members, an association should demonstrate that it takes vigorous action against members who violate its rules; conducts proceedings in a manner consistent with the fundamental elements of due process; and imposes discipline which is fair and has a reasonable basis in fact. NFA's membership includes registered futures commission merchants ("FCMs"), introducing brokers ("IBs"), commodity pool operators ("CPOs"), commodity trading advisors ("CTAs") and persons associated with these registrants ("APs").⁶

⁵ 7 U.S.C. § 21 (2000).

⁶ FCMs that carry funds of customers trading commodity interests must become members of a registered futures association. (Commission Regulation 170.15.) NFA Bylaw 1101 prohibits an NFA member from doing business with a non-member (other than a floor broker) where the non-member (1) is required to register with the Commission as an FCM, IB, CPO, CTA, (2) is acting with respect to an account, order or transaction for any other person, and (3) is not a member of another registered futures association. Exceptions are provided for (1) notice-registered FCMs and IBs, where the transactions involve solely security futures products, and (2) other cases that NFA's Board specifically excludes. Consequently, an FCM, IB, CPO, or CTA that conducts futures business with the public or with a member of NFA must, subject to those exceptions, itself also be a member of NFA. NFA had 53,395 members as of March 31, 2002.

B. Overview of NFA Disciplinary Process

NFA conducts routine compliance activities with respect to its members, including periodic audits and reviews of financial reports, as well as review of promotional materials submitted by members. NFA also addresses other indications of potential problems, including those brought to its attention (such as customer complaints, information provided by other members, and referrals from other self-regulatory and regulatory organizations) and those it finds itself through surveillance of the Internet, various publications, and television and radio advertising.

Less serious problems noted through compliance activities are generally brought to the attention of the Member, who is given the opportunity to make the changes necessary to return to compliance. In many cases, NFA will accept the Member's oral representation that the changes will be made. In some instances, however, NFA will request that the Member respond in writing regarding specific problems noted. The Division's review of NFA's follow-up to problems noted in its compliance activities is discussed in more detail in Section V.A.2, below.

When NFA's Compliance Department identifies more serious or repetitive violations of NFA rules, the matter is brought to the attention of the Enforcement Coordinator, who works within the Office of the General Counsel. If the Enforcement Coordinator and Compliance decide that the matter is appropriate for prosecution, the Enforcement Coordinator or an Enforcement Attorney will coordinate additional investigation. If there is sufficient evidence, a recommendation will be made to the BCC that it issue a complaint against a member firm and/or individual members. The BCC acts in the role of grand jury, determining whether a complaint should be issued. As is the case with a grand jury, it is rare that the BCC refuses to follow a recommendation to issue a complaint.⁷

The respondent has a right to a hearing. Hearings are conducted by a three-person panel of members of NFA's Hearing Committee. A respondent aggrieved by the decision of a Hearing Panel has a right to appeal the decision to NFA's Appeals Committee, which is a subcommittee of NFA's Executive Board; the Compliance Department may petition for appeal of a decision. Most complaints are resolved by settlement, either before or after the respondent files a formal answer.

Separate from the disciplinary system, NFA rules provide for a Member or Associate Responsibility Action ("MRA") for cases where there is reason to believe that immediate action is necessary to protect customers, the markets, or

⁷ NFA staff indicated that the BCC does, on occasion, recommend that fewer or additional charges be brought, or that fewer or additional members be charged.

other members or associates.⁸ An MRA is taken at the direction of the President of NFA, with the concurrence of the Board of Directors or the Executive Committee. Under an MRA, the President of NFA may summarily suspend a member or associate, restrict its operations, or direct it to take remedial action. The taking of an MRA does not preclude NFA from taking a disciplinary action involving the same matters or persons, nor does the existence of a pending or completed disciplinary action preclude an MRA. NFA's rules establish procedures for notice to the respondent of the taking of an MRA, as well as for a prompt hearing by a Hearing Panel to determine whether the MRA should be affirmed, modified or vacated. Commission Rules provide for review by the Commission of MRAs, either before or after the hearing by the Hearing Panel.

In a 1997 internal report, NFA's Legal/Compliance Workflow Team examined NFA's investigations process and made several recommendations for procedural improvements. These recommendations included appointing an Enforcement Coordinator to manage the disciplinary process, as well as other changes intended to focus the investigative process and enhance training of, and coordination among, NFA Compliance and Legal staff. A second report in 1998 reviewed the disciplinary process from the time a BCC complaint is issued to its conclusion, and recommended changes to NFA rules and procedures to expedite the resolution of disciplinary matters. These reports are discussed in further detail in the Appendix. NFA has implemented many of the changes recommended in these reports and NFA staff expressed their views that the process has been improved due to the changes. In particular, NFA staff stated that the implementation of pre-hearing procedures has decreased the amount of time needed to resolve cases in which answers are filed and streamlined the hearing process. These procedures are discussed in more detail in sections V.D, V.E and V.F, below.

IV. SCOPE OF THIS REVIEW

The Division reviewed NFA's disciplinary program to assess its overall effectiveness in addressing violations of NFA rules found by NFA's Compliance Department. The Division's review focused on NFA's procedures for:

- 1) determining which compliance problems merit formal disciplinary action;
- 2) addressing informally problems that have been determined not to merit formal disciplinary action;
- 3) conducting investigations of problems which have been determined to merit formal disciplinary action, and referring such matters to the BCC;
- 4) issuing BCC complaints; and
- 5) resolving BCC complaints either by adjudication, default decision or settlement.

The review did not focus on NFA's procedures for identifying compliance problems in the first instance. Due to the difficulty of defining objective

⁸ NFA Compliance Rule 3-15.

standards, the Division did not evaluate the complexity of enforcement cases NFA brought, and thus did not evaluate whether the time spent investigating such cases was appropriate. The Division did not question NFA's decisions to address a compliance problem through remediation rather than enforcement except in a few particularly noteworthy cases of repetitive violations.

The Division's review of NFA's Program focused on matters initiated in the Compliance Department during the period from January 1, 1999 through June 30, 2000 ("target period"). Division staff chose a period ending prior to initiation of this review in order to allow sufficient time for NFA's investigation and complaint processes to take place prior to testing.

The Division gathered and evaluated information from a number of sources in its review:

1. Interviews with officials of NFA, including the General Counsel, Enforcement Coordinator, Executive Vice President/Chief Compliance Officer, Senior Vice President for Compliance, and Director of Compliance. Division staff also interviewed Enforcement Attorneys, Counsels to Panels, and legal support staff from the Legal Department; and Associate Directors, Team Managers, and Field Supervisors in the Compliance Department.
2. Samples from each of the three main categories of the Compliance Department's activities – audits ("EXMs"), financial investigations ("FINs") and other matters, such as customer complaints, promotional material and referrals from regulators ("INVs"). Division staff reviewed electronic and hard copy audit files, hard copy FIN and INV files, and INV and EXM statistics in NFA's FACTS system.⁹
3. Investigations and BCC complaints that resulted from EXMs, FINs and INVs conducted between January 1, 1999 and June 30, 2000.
4. NFA's training programs for Compliance Department staff in conducting investigations, and for members of the Hearing Panel, which Division staff attended; and written materials included with the programs.
5. Written procedures for selection of hearing panelists and counsels to panels.
6. Examples of materials prepared for BCC meetings.

⁹ FACTS is the Financial Analysis & Audit Compliance Tracking System, NFA's mainframe database for financial data, audit and other compliance information about NFA member firms. Subsequent to the Division's completion of field work, NFA has phased out FACTS in favor of FACTS 2000, an enhanced, PC-based version of FACTS.

7. *Report of the Legal/Compliance Workflow Team* (December 1, 1997) and *Disciplinary Proceedings Innovation Team: Report and Recommendations* (August 13, 1998), NFA's internal reports on its own investigative and disciplinary processes.

V. REVIEW FINDINGS

A. NFA's Processing of Inquiry Items and Identification of Problems

1. Staffing and Organization of NFA's Compliance Function

NFA's principal office is located in Chicago, Illinois, with a second office in New York. The Chicago office compliance staff is responsible for 35 central and western states and all U.S. territories and possessions. The New York office compliance staff is responsible for 15 states and the District of Columbia. During the period subject to review, NFA's Compliance Department included approximately 150 staff, with approximately 120 in Chicago and approximately 30 in New York. NFA's Compliance Department includes several teams, each of which is headed by an Associate Director and includes four to five Team Managers, five to seven Field Supervisors, and approximately nine Staff Auditors.

Among the staff the Division interviewed, Associate Directors had 16 to 18 years experience with NFA, Team Managers between five and 16 years, and Field Supervisors approximately four years. Most of these staff members obtained experience and received training primarily in-house, on the job, and through industry seminars and other outside sources. One of the staff members we interviewed had attended a seminar for certified fraud examiners.

2. Activities of the Compliance Department¹⁰

a. Audits ("EXMs")

NFA conducts field audits of its various types of members (FCMs, IBs, CPOs and CTAs) using several different audit modules.¹¹ During a field audit, NFA staff review the business operations of a member firm for compliance with Commission and NFA rules. The planning and scope setting module at the

¹⁰ See also the Division's prior reports on its reviews of NFA's compliance program for CPOs and CTAs (July 1997) and FCMs and IBs (September 1998). The latter report is available at www.cftc.gov/files/tm/tmfarer092998.htm.

¹¹ The modules are: Audit Planning and Scope; Affiliates; Block Orders; Cash Activity; CPO Disclosure Documents; CPO Reporting; CTA Disclosure Documents; Margins; Promotional Material; Records; Registration/Bylaw 1101; Segregation; Seldom Seen Issues; Solicitation; Subsequent Review; Supervision; Net Capital; Trading; and Order Processing.

beginning of the process allows NFA to assess a number of factors in deciding which of the audit modules will be performed in the particular examination. In planning the scope of an audit, Compliance staff consider factors including problems noted in prior audits, customer complaints and other matters noted in the INV log since the last audit, and the disciplinary history of the firm and its APs.

NFA has issued guidelines¹² that establish the following cycle for auditing its members: FCMs carrying customer accounts are audited annually; members at the top of the audit priority list¹³ are audited at least every other year; 75% of newly active members are audited within the first year of operation, with the remaining 25% audited within two years; for previously audited members, 50% on a three-year cycle, 75% on a four-year cycle, and 100% within five years of their last audit. Members whose only customers are Qualified Eligible Participants¹⁴ will be audited within seven years. Routine audits are conducted using NFA's audit programs that include both financial and sales practice procedures.

During the course of an audit, compliance problems may be found. These issues are brought to the attention of the firm while auditors are in the field and the firm's responses are documented in the internal control workpaper ("I/C"), or occasionally in the workpaper applicable to the issue. The I/C workpaper includes a description of the issue; any explanation the firm has provided; the steps the firm has taken or has agreed to take to fix the problem; and an indication of whether NFA staff will include the item in the audit report or pass on reporting it. Each problem is brought to the attention of the Field Supervisor and Team Manager. In addition to citing items in the audit report, the Compliance Department may issue staff letters advising a Member of certain violations and generally noting that further violations may result in disciplinary action. Information regarding the audit is maintained in NFA's FACTS system.

Issues that are determined by the Field Supervisor and Team Manager to be serious are brought to the attention of the appropriate Associate Director. The Associate Director may decide that a staff letter is appropriate, or may consult with the Enforcement Coordinator to determine if the matter should result in a disciplinary investigation.

¹² See NFA *News, Facts, Actions*, March 1998; at www.nfa.futures.org/news/newsfactsactions/nlmar98_6.html; accessed March 6, 2002.

¹³ NFA's audit priority system assigns points to a firm based on a number of factors, such as disciplinary history; prior audit results or lack of recent audit; amount of funds and number of accounts managed; review of financial reports, disclosure documents and promotional material filed; and the telemarketing "watch list" which tracks the number of associated persons employed who were previously employed by firms disciplined for fraud.

¹⁴ "Qualified Eligible Participant" is defined in Commission Regulation 4.7(a).

Division staff reviewed a sample of 30 audits selected randomly from all 1201 audits conducted during the target period; 15 audits selected randomly from the 90 audits where NFA records indicated that staff letters were sent; and all 17 audits during the target period that resulted in BCC actions.¹⁵ The audit workpapers were reviewed to determine how Compliance staff handled problems of varying severity that were discovered during the audits.¹⁶

For each of the audits in the sample in which the I/C included deficiencies that were reported to the firm, Division staff reviewed the firm's response noted in the I/C or any referenced workpaper. Division staff distinguished cases where the firm's oral representation that corrective action would be taken was considered sufficient from those cases that documented either corrective action demonstrated by the firm or a written representation that such corrective action had been or would be taken.

The Division's review disclosed that for the majority of problems found, NFA accepted the firm's oral representation that corrective action would be taken and did not require any written representation or documentation that the problem had, in fact, been corrected. NFA found deficiencies in 51 of the 59 audits in the sample. NFA noted 524 deficiencies in these audits.¹⁷ For 88 of the deficiencies noted, corrective action was documented. For 339 problems, NFA accepted the firm's representation that the problem would be corrected. No member firm response was noted in the audit workpapers for 97 deficiencies. However, of the nine audits for which no firm response was noted, six were recommended to the BCC for action. These six cases included 91 of the 97 problems for which no response was noted. Written responses were requested by NFA on 114 issues, from 12 firms.

The Division's review confirmed that the NFA audit scope selection process reliably includes consideration of problems noted in prior audits. For the audits in the sample for which problems had been reported to the firm, Division staff examined either a prior or subsequent audit (1) to test the manner in which prior violations are handled in scope setting, and (2) to determine whether repeat violations are handled with an increased degree of response.¹⁸ The Division found that in every case, the firm's prior problems were considered in setting the

¹⁵ Due to overlap among the three samples, Division staff reviewed a total of 59 audits.

¹⁶ The scope of the review of Compliance Department functions was limited to evaluation of the process for addressing problems and did not assess the effectiveness of the audit program as a whole.

¹⁷ The number of deficiencies includes each item which NFA's I/C workpapers indicated was reported to the firm, as well as a small number of items which were included in the audit report but not documented in the I/C.

¹⁸ Of the 51 audits for which problems were reported, 25 had been audited either in the five years prior to, or subsequent to, the audit included in the target period.

scope of the audit. Further, in almost every case in which the problems recurred, NFA noted this fact in its audit workpapers or in the audit report provided to the firm.

For many problems that recurred, however, NFA again accepted the firm's representation that the problem would be fixed and did not require the firm to document that the corrections had been made. Of 101 total problems reported in the initial audits, 38 were identified as recurring problems in the second audits. For 18 of these recurring problems, however, NFA again accepted the firm's oral representation that corrective action had been or would be taken.

b. Investigation Matters ("INVs")

NFA classifies as investigation matters ("INVs") inquiries commenced based on information received from various sources, including customer complaints, complaints from Members, referrals from federal and state regulators and other SROs, and in some cases, information discovered in the routine audit process. Documentation regarding INVs is maintained in NFA's FACTS system.

During the Division's interviews, NFA Compliance Department staff explained that they generally receive and document complaints while on "phone duty". Customers with complaints call the NFA's Information Center, which refers these calls to the Compliance Department. Each Compliance Department team is assigned to phone duty on a rotating basis, two weeks at a time. A complaint regarding a specific member firm (or an AP of a specific member firm) is forwarded to the audit team to which the firm is assigned. The Team Manager will review the matter and assess what further work is necessary. An INV may not be opened where the customer does not provide the firm name, or where the allegations, on their face, do not appear credible. On the other hand, Compliance staff will assess a complaint made anonymously if it contains serious, credible allegations.

An INV may also be commenced based on information referred to NFA by the Commission, the Securities and Exchange Commission, other federal agencies, state regulatory agencies, or other futures and securities SROs. The review process for information received through these referrals is essentially the same as the process for evaluating complaints received from customers or Members.

Examinations of promotional material submitted by Members are also classified as INVs. Promotional material may be submitted voluntarily for review prior to use pursuant to NFA's pre-review program or may be filed after first use due to a Member-specific requirement imposed by the Compliance Department.¹⁹

¹⁹ Pursuant to NFA Compliance Rule 2-29(g), the Compliance Director may require any member, for any specified period of time, to file promotional material with NFA promptly after its first use.

In addition, certain Members may be required to submit promotional material for pre-approval pursuant to NFA's telemarketing program,²⁰ NFA Compliance Rule 2-29(h),²¹ or a disciplinary decision or settlement agreement.

The staff assigned to the INV will review the initial information (e.g., record of complaint, promotional material) and determine whether similar complaints have been made against the AP or firm. An INV number will be assigned and staff will discuss action steps. For an INV that appears more serious, a team may be assigned. For a complaint, NFA staff will contact the firm, contact the customer, and obtain relevant documents from each party. If the review discloses potential violations, a staff letter may be sent. The Team Manager will assess the severity of the violations and may consult with the Associate Director. NFA staff noted that, if the INV involves a repeat violation, NFA may follow up with an audit or close the matter into an audit that has been scheduled or is in progress.

Compliance Department staff routinely review Members' promotional material as part of the audit program. In addition, NFA staff review promotional material submitted to NFA. If NFA's review of materials filed for pre-review discloses a problem, staff will call the firm and record this information in the INV notes. NFA may send a letter if staff is not able to contact the firm by phone or if the firm requests one. A hard copy of the letter is placed in the INV file, which is cross-referenced by the firm's NFA ID number.

If the deficiency is minor, NFA may call the firm, document the issue in the FACTS notes screen, and add priority points. If the deficiency is more serious or a second occurrence, a letter would be sent notifying the firm of the problems and stating that the firm must stop using the material. The letter will ask the firm to respond either by correcting the material or by representing that it will stop using the material. The firm's agreement generally is documented in the FACTS notes. Staff may also recommend an audit.

²⁰ NFA Compliance Rule 2-9 specifies that firms that have met certain criteria with respect to the prior employment of their sales forces by firms disciplined for fraudulent telemarketing practices must comply with enhanced supervisory procedures. These procedures include filing all promotional material at least ten days prior to its first use. NFA Interpretive Notice ¶ 9021, Compliance Rule 2-9: Enhanced Supervisory Requirements (Board of Directors, January 19, 1993; revised August 14, 1996, December 16, 1996, March 10, 1998, July 1, 2000, January 1, 2001 and June 1, 2001).

²¹ NFA Compliance Rule 2-29(h) requires that any Member who uses or directly benefits from any radio or television advertisement that makes any specific trading recommendation or refers to or describes the extent of any profit obtained in the past or that can be achieved in the future must submit the advertisement to NFA's Promotional Material Review Team for its review and approval at least ten days prior to first use, or such shorter period as NFA may allow in particular circumstances.

Division staff reviewed a total of 49 INVs: 30 selected randomly from all 3274 INVs opened during the target period; 15 selected randomly from the 73 INVs where NFA records indicate that staff letters were sent; and the four INVs during the target period that resulted in BCC actions. Of these, 25 were promotional material reviews; 13 related to customer complaints or inquiries; one was a restitution case; two were related to registration filings; one was based on late financial filings; two were complaints from other NFA Members; one was a referral from a state regulator; and four were based on information found in audits of other Members. NFA found compliance problems in 32 of the 49 total INVs and sent staff letters in 17 of these cases.

In 15 of the 32 cases where compliance problems were found, NFA did not obtain a written response from the firm and took no further action. Specifically, in ten cases of compliance problems, NFA accepted an oral response from the firm. In five other cases, NFA records disclose no action against the firm, despite receiving no response from the firm. In 14 cases, NFA's records indicate a written response from the firm. In two cases, NFA referred to the BCC firms that failed to respond; in another case, the INV was closed into an audit. In the 17 cases in which staff letters were sent, written responses were documented in eight cases and oral responses were documented in four cases. In five cases in which NFA sent letters, neither an oral nor written response was documented.

c. Financial investigations (FINs)

Compliance staff routinely review monthly, quarterly or semiannual unaudited reports, and annual certified reports, filed by FCMs and independent IBs.²² A financial investigation, or FIN, is opened when NFA's review identifies a problem concerning the firm's compliance with financial requirements. Of the 7,695 financial reports reviewed during the target period, 64 FINs were opened. NFA staff indicated in interviews that a staff letter is likely to be sent in FINs; staff letters were sent in 47 of the 64 FINs. The severity of the financial problem is a factor in determining whether oral or written documentation of remedial action is requested. NFA staff are more likely to ascertain that remedial steps have been taken in the case of FINs than in the case of EXMs. With FINs, the Associate Director is typically involved in the determination of whether to issue a staff letter and whether to refer the matter for disciplinary action.

The Division found that, in the majority of FINs where problems were found, NFA staff obtained a demonstration from the firm that corrective action had been taken. The Division reviewed a sample of 30 FINs selected randomly from the 64 FINs conducted during the target period; 15 FINs selected randomly from the 47 FINs where staff letters were sent; and the five FINs during the target

²² In May 2001, the Division issued a report on its review of NFA's program for review of FCM and IB financial reports. This report is available at www.cftc.gov/files/tm/tmnrar050101.pdf.

period that resulted in BCC actions. Compliance problems were identified in 40 of these cases. Completion of corrective action was documented in 31 of the 40 cases, and partial completion was documented in two cases. In three additional cases, no response from the firm was documented, and the cases were referred to the BCC. In one case, the firm represented that corrective action would be taken, and the compliance problems were addressed in an audit that took place shortly after the FIN.

Thus, in 37 of the 40 FIN cases where staff found compliance problems, NFA either obtained documentation of corrective action or took enforcement action. Corrective action was generally accomplished by filing notices specified in CFTC Regulations and NFA Financial Requirements, providing an explanation of the causes for the firm's non-compliance, and documenting that the problem had been corrected.

In two cases, the firm represented that corrective action would be taken, but completion was not documented. In one case, NFA's records indicate that staff contacted the firm's CPA and informed him of their view that an equity withdrawal was taken in violation of NFA financial rules, but did not document in any way the CPA's (or the firm's) reply.

3. Division Comments

NFA's failure to obtain documentation demonstrating that member firms had corrected compliance problems identified during audits and investigations, or at least written agreements to correct violations, is troubling. Oral agreements are considerably less effective, both because the firm is less likely to appreciate the significance of an oral agreement, and because it is more difficult to prove what a firm representative actually agreed to where the only record of the agreement is a note by an NFA staff member. The cases where NFA's records did not document any response by the firm are much more problematic. If the firm simply ignored NFA's reports of compliance problems, it is unlikely that that firm took action to correct the problems. While it is possible that, in some of these cases, a response was received but not documented, it is impracticable for NFA staff to enforce or otherwise follow up upon an unrecorded commitment to take corrective action.

Accepting oral representations that repetitive compliance problems will be remedied is a questionable practice. If a problem is repetitive, then the steps taken when the problem was cited before have not been effective. This suggests that different steps should be employed. While a repetitive problem may not warrant referral to the BCC, NFA staff should strongly consider taking steps, outside the normal audit cycle, to verify that the firm has taken effective remedial action.

B. Investigation of Serious Problems Identified

1. Overview

Where NFA staff identify serious compliance problems, they consult the applicable Associate Director to determine whether the matter warrants referral for disciplinary action. Compliance staff may seek advice regarding this determination from the Enforcement Coordinator or Enforcement Attorneys. This decision may be based on a variety of factors, including an evaluation of the seriousness of the violation, an evaluation of the quality of the proof that the Enforcement Attorneys might bring to the Hearing Panel (i.e., the strength of witness testimony or documentary evidence), or the existence of a Commission investigation concerning the same firm. In determining whether promotional material violations may result in disciplinary action, NFA considers whether the material has already been delivered to potential customers.

NFA procedures indicate that once Compliance staff and the Enforcement Coordinator determine that a case should result in disciplinary action, it should be placed on the Investigation Log, referred to as the "A-log," and an Enforcement Attorney assigned. The Compliance staff prepare a case summary, and the attorney may formulate a "game plan" document (discussed below). The A-log tracks all active investigations and includes the names of the parties, the violations being investigated, names of staff assigned, the initiation date of the investigation, the initial game plan meeting date, and the planned completion date.

NFA staff indicated that their goal is to complete investigations within six months. In a relatively simple case, the investigation may take only a month; in more complex sales practice cases, the investigation may require up to a year. Division staff found that this goal has been met: the total time for investigations in our sample²³ ranged from 21 to 373 days, with a mean of 170 and a median of 176.

Division staff found four cases in our sample in which NFA determined to conclude an investigation prior to its inclusion on the A-log, or raised the possibility of BCC action with the member but determined not to proceed. The rationale for NFA's decisions not to proceed with disciplinary actions in these cases was not clearly documented in the materials the Division reviewed. In discussions with Division staff, NFA staff explained their reasons for deciding not to recommend BCC action in each of the four cases. These decisions were based on factors such as NFA staff's evaluations of their ability to prove their case based on available evidence and witnesses, and whether the violations appeared sufficiently egregious to warrant prosecution.

²³ The total number of days was calculated from the date the INV, EXM or FIN was initiated to the date a BCC complaint was issued.

2. Case Summary

Compliance staff will generally prepare a case summary to document for the Enforcement staff the Compliance Department's findings; however, the audit report or other written materials, such as a detailed referral from a regulatory agency, may serve the purpose of a case summary. The case summary includes the names of the Compliance staff assigned to the investigation; the allegations; the subjects of the investigation; a description of the work completed and evidence gathered; and dates on which the Compliance staff would be available for an initial game plan meeting. Case summaries were prepared in ten of the 25 BCC cases in the Division's sample. In four cases, the audit report served as the case summary. In seven cases, other written materials, such as the Notice of MRA or staff memoranda, served as the case summary. Four of the cases were single-issue cases involving financial violations for which an oral summary was considered sufficient.

3. Game Plan

NFA's procedures specify that a game plan meeting should be held after a case is placed on the A-Log. As suggested in the 1997 Report of the Legal/Compliance Workflow Team, the purposes of the game plan meeting are to identify what the case is trying to prove, the investigative steps that need to be completed and who is responsible for completing those steps; and to establish realistic deadlines for the completion of each step and the investigation itself. Participants include the Enforcement Attorney and the Associate Director, Team Manager, Field Supervisor, and possibly an auditor from the responsible Compliance Department team. A written game plan may be prepared. The Enforcement Attorney will write the game plan with input from Compliance staff, who also have the opportunity to review the completed draft. Subsequently the game plan is reviewed by the Enforcement Coordinator and the Executive Vice President/Chief Compliance Officer, who may revise the plan.²⁴

NFA staff indicated that the use of the game plan significantly increased the efficiency and effectiveness of their investigations. The game plan is intended to be a flexible document that may be changed as the investigation progresses. The game plan narrative includes the background of the matter, the subjects of the investigation and the allegations. A timeline, in the form of an Excel spreadsheet, is also prepared and is attached to the game plan. The timeline lists the tasks to be done, specific staff assigned, and due dates. Milepost meetings are held in more complex cases to assess the status and to keep the Enforcement Coordinator and Executive Vice President apprised of the investigation's progress.

²⁴ The Enforcement folder in public folders maintained through Microsoft Outlook is used to keep track of the case summary and game plan documents. Although Legal and Compliance staff may access the Enforcement folder to read these documents, data input is done only by the senior paralegal.

NFA staff indicated that game plans were generally prepared, except in cases that would not require extensive investigation after placement on the A-log. For example, in financial cases and some audits, the investigation frequently may have been conducted in the context of the FIN or EXM before the Enforcement Coordinator is consulted.

The Division's review found that formal game plans or equivalent documents were prepared in only seven cases in our sample; in 18 others, no game plan was prepared. In six of these 18 cases, a BCC complaint was brought within 29 or fewer days of the case's entry upon the A-Log. This quick turnaround suggests that the investigations were complete (or nearly so) upon placement on the A-Log. In eight other cases, the BCC complaint was issued between 50 and 86 days after the case was placed upon the A-Log. Given that the BCC meets approximately every six weeks, a case where the investigation is complete just after the deadline for the next BCC could reasonably fall within this time range. In four cases where no game plan was prepared, however, the time between entry on the A-Log and the BCC complaint ranged from 107 to as many as 221 days. It thus appears that game plans were absent in at least a few cases which required lengthy investigations.

4. Discovery Procedures

Additional steps taken in the investigation may include interviews with customers who have made complaints or who are potential witnesses; review of firm financial records, customer account documents, and tapes or transcripts of phone conversations between APs and customers; depositions; and interrogatories. Initial customer interviews are likely to be done by Compliance Department staff. The Enforcement Attorney interviews customers who are potential witnesses in the case, conducts depositions (generally with the assistance of a Compliance staff member), and prepares interrogatories. Because the scheduling and taking of depositions can be very time-consuming, depositions are being used less than they have been in the past and other measures, such as teleconferencing, are being used where possible to expedite depositions.

5. Investigative Report

Once an investigation has been completed, the Enforcement Attorney prepares an investigative report. The report includes an introduction, a description of the findings of the investigation, and a recommendation that the BCC issue a complaint. NFA staff said that they could not recall any recent cases that had been investigated but did not result in a recommendation to the BCC for a complaint.

A draft of the investigative report is circulated to the Compliance staff that have participated in the investigation, and their comments are incorporated. The draft then goes to what is referred to as "Wednesday morning," which,

historically, was the meeting held after completion of the investigative report. In the past, the Wednesday morning meeting was open to all senior Compliance staff, who could provide input on the report. Currently, Wednesday morning refers to the final step of giving the report to the Executive Vice President; if he has significant questions about the report, he will meet with the team. After this review, the report may be revised or returned to the team for further investigation.

6. Division Comments

The Division recommends that NFA's Legal Department document its rationale for declining to prosecute cases of serious compliance problems that the Compliance Department has brought to it for consideration. The Division is not questioning the appropriateness of NFA's use of prosecutorial discretion in reaching these decisions. However, we recommend that NFA improve its documentation of its rationale for such decisions so that: 1) NFA can better use the information in its future dealings with the member firm; 2) NFA can use this information to identify areas for improvement in its rules or enforcement program; and 3) the Division has sufficient information to be able to fulfill its oversight responsibilities.

The Division suggests that NFA consider increasing its use of game plans in all but the least complex cases. The use of game plans was recommended in the Report of the 1997 Legal/Compliance Workflow Team, and NFA staff clearly believe that game plans are helpful. In order to test this conclusion, however, the Division would have had to evaluate the complexity of each case in the sample and relate that evaluated complexity to the time from initiation to complaint. Such an evaluation was outside the scope of this review.

C. The BCC

1. Presentation of Recommendation to BCC

The BCC meets approximately every six weeks. Once the investigative report is approved, it goes into the package of materials that are sent to BCC members a week prior to their scheduled meetings. A Compliance staff person who has had substantial involvement in the investigation makes an oral presentation of the investigative report to the BCC. Other investigative team members, as well as the Enforcement Coordinator and Executive Vice President/Chief Compliance Officer, may also attend the meeting and may be called upon to answer questions raised by the BCC. The BCC may accept the staff recommendation, or it may add to or change the complaint. In one recent case, for example, the BCC recommended adding a party to the complaint.

2. BCC Decision to Issue Complaint

The Enforcement Attorney drafts the complaint, generally prior to the BCC meeting so that the draft can be included in the BCC package or given to the BCC at the meeting. If the BCC agrees with the Compliance Department's recommendation, the prepared complaint can be signed at the meeting or shortly thereafter.²⁵ If the BCC decides to issue a complaint that differs from what the Compliance Department has recommended, the attorney will edit the complaint. Only rarely does the BCC deny a staff recommendation to issue a complaint, and it has not done so recently.

3. Service of Complaint

After the BCC has approved issuance of a complaint, NFA's docketing staff verify addresses for service, prepare an affidavit of service, and serve the complaint by overnight delivery. The complaint is docketed on Legal Edge, a database system used for internal tracking of the disciplinary process, and the case number, party name(s), narrative and summary of the case are added to BASIC, NFA's online system for providing public access to disciplinary and other background information on Members.

In the cases reviewed, Division staff did not find any deficiencies in the documentation of the service of complaints in accordance with the procedures specified.

D. Answer to Complaint

The respondent is notified in the complaint that an answer must be filed with NFA within 30 days. NFA staff indicated that the Enforcement Attorney is authorized to grant a two-week extension for the answer, and that any further extensions must be approved by a committee of the BCC. When an answer to a complaint is filed, NFA treats it as a request for a hearing and the matter is forwarded to the docketing staff for assignment of a Hearing Chair.²⁶

If an answer is not received by the due date, the Legal Edge system produces an alert. The docketing staff will check with the Enforcement Attorney to see whether an extension has been given. If no extension has been granted, docketing staff send a letter stating that NFA has not received an answer. If

²⁵ In 17 of the 25 cases in the sample, complaints were issued within two days of the investigative report date/BCC meeting.

²⁶ Prior to the 1998 report of the Disciplinary Proceedings Innovation Team, the respondent was required to request a hearing explicitly. NFA staff indicated that automatic granting of a hearing has streamlined the process and eliminated difficulties in tracking cases in which answers were filed but no hearing was requested.

there is still no response seven days after the date of the letter, the matter will be returned to the BCC for a default decision. Docketing staff will check for proof of service, and may also check with the Enforcement Attorney to determine whether there was a reason for the failure to file an answer, such as settlement discussions. Any additional requests beyond the two-week extension that staff may grant must go to the BCC. A subcommittee of the BCC handles these extension requests.

The Division's review revealed that NFA's policies on granting extensions are approximately, though not strictly, followed. Eleven respondents in our sample requested at least one extension; in all but one of these cases, the initial extension was granted. Most of the initial extensions were for two weeks or less; three extensions were granted for periods from 18 to 28 days. In the one case where the request was not granted, the respondent submitted a settlement offer the day after the extension request was denied. In four cases, an additional extension was requested and, for one of the respondents, granted. Two of the other respondents concluded settlement agreements shortly after their additional extension requests, and the third respondent submitted an answer a week after the first extended deadline.

E. Selection of the Chair of the Hearing Panel

NFA uses written guidelines for selection of Hearing Chairs and Hearing Panelists. Hearing Committee members are categorized in three groups: Category A, includes six panelists who are considered qualified to chair panels hearing complex cases; Category B, the largest group, includes approximately 30 panelists considered qualified to serve as panelists or as chairs for less complex cases; and Category C, approximately eight people, who serve only as panelists. The Senior Paralegal selects the Hearing Chair from the appropriate category on a rotating basis. If the panelist whose turn it is has a scheduling conflict, she will proceed successively down the list until an available Chair is found.

At the same time a Hearing Chair is selected, counsel to the Hearing Panel is also assigned. Three attorneys on the Legal Department's staff serve as counsel to panels. These attorneys are not involved in the enforcement process. The Counsel to the Panel assists the Panel in the procedural aspects of the pre-hearing process and the hearing, is responsible for sending correspondence and orders relating to the pre-hearing and hearing procedures, and drafts the decision of the Hearing Panel.

F. Pre-hearing Procedures

1. Pre-Hearing Conference

Once the Hearing Chair has been selected, arrangements are made for the pre-hearing conference. After obtaining several available dates from the

Chair, the Senior Paralegal will check with respondents and the NFA attorney for their availability. The Senior Paralegal will schedule the pre-hearing conference and make arrangements for teleconferencing. She will also send a letter to the Hearing Panel Chair which transmits the BCC complaint and respondent's answer. The Chair will issue an order setting the date of the pre-hearing conference. The Counsel to the Panel will then distribute the pre-hearing conference order and agenda to the parties. The Enforcement Attorney handling the case for NFA and the Counsel to the Panel also participate in the pre-hearing conference. Matters determined at the pre-hearing conference include setting hearing dates; establishing deadlines for discovery, exchange of witness lists and evidence; and determining timeframes for filing motions and responses to motions. A second order is issued after the pre-hearing conference has been held, documenting the dates set and any other determinations made at the pre-hearing conference. Docketing staff ensure service of all pre-hearing orders on all parties to the matter and docket the orders in Legal Edge.

2. Motions

Motions filed by any party to the matter are handled by the Hearing Panel. Motions generally relate to discovery, venue, continuance, and acceptance of telephonic testimony. Cases in the Division's sample included motions for discovery, continuance, and use of telephonic testimony from certain non-party witnesses. While most of the motions were made by respondents, in one case NFA submitted a motion for continuance pending the outcome of a civil matter on related issues, and in another case NFA filed a motion to set a deadline for submission of a respondent's settlement offer. NFA also submitted responses to respondents' motions in two cases.

The Division examined a sample of motions. The Hearing Panel decided all motions in the sample, whether contested or consent, within ten days. For the contested motions, the orders issued by the Panel contained an explanation of the reasons for the Panel's decision.

G. Hearing

The hearing begins with an opening statement from the Hearing Panel Chair in which the parties are identified and the hearing procedure is outlined. The parties then follow with their opening statements, starting with the NFA attorney. NFA presents its case first, with respondents allowed to cross-examine witnesses. Respondents are then allowed to present their defense, with NFA allowed to cross-examine. NFA is then provided an opportunity to call rebuttal witnesses and present rebuttal evidence. Parties then provide their closing statements, again beginning with NFA.

While each panel member has an equal vote on issues that arise during the hearing, panel members may agree that the Chair has the authority to rule

unilaterally on minor issues. Panel members may request additional explanatory materials or even legal briefs on specific issues. Panel members may question witnesses, generally at the end of a witness's examination.

NFA is represented by one or two NFA Enforcement Attorneys. The Panel has the authority to compel testimony from NFA members and NFA staff. A respondent's request for the testimony of a particular Compliance staff member is generally honored. Closing arguments are generally delivered orally, although there may occasionally be written arguments and proposed findings of fact. The Enforcement Attorney will address sanctions in the presentation and include a recommendation as to the type of penalty and possibly the range of a fine or suspension.

H. Settlement

Pursuant to NFA Compliance Rule 3-11, the subject of an investigation, or a respondent in a disciplinary matter, may submit a settlement offer to the NFA Committee or Panel that is responsible for the matter at the point in the process at which the offer is made.²⁷ In cases where the respondent is aware of the likelihood of a BCC complaint prior to its issuance, a settlement offer may be accepted simultaneously with the issuance of the complaint.

The Committee or Panel may accept the settlement offer, and issue a decision to that effect; or may reject the offer. If the offer is rejected, the Committee or Panel may provide guidance as to what terms would be acceptable. Decisions on settlement by the BCC or Hearing Panel are furnished to NFA's president and become final within 15 days unless the president determines to refer the matter to the Appeals Committee.

In practice, the Enforcement Attorney and respondent typically discuss the terms of a possible settlement and reach an agreement prior to submission of a written offer. The Enforcement Attorney will discuss the settlement offer with Compliance Department staff, the Enforcement Coordinator and Executive Vice President/Chief Compliance Officer.²⁸ Once NFA receives an offer in writing, staff will generally recommend that the BCC or Hearing Panel accept it. The staff recommendation is documented in a memo to the BCC or Hearing Panel that describes the allegations in the complaint and the respondent's offer. However, the basis for the staff recommendation as to whether to accept the settlement offer is documented in conclusory terms, if at all.

²⁷ Prior to the selection of a Chair of a Hearing Panel, the BCC or its designated panel has jurisdiction; after that point, the Hearing Panel has jurisdiction. If the case is on appeal, the Appeals Panel has jurisdiction.

²⁸ Indeed, NFA staff will frequently come to an internal consensus as to an acceptable level of sanction prior to submitting the case to the BCC.

Most disciplinary cases are settled prior to a hearing being held. Of the 25 cases the Division reviewed, 24 complaints were resolved by settlement. Hearings were held in the remaining case, a complex sales practice matter. Some of the charges in this case were sustained by the Panel, others were not.

I. Decisions

The Panel generally meets immediately following the hearing. The Panel is required to address each of the charges contained in the complaint. Panelists must decide whether the respondent committed the alleged acts or omissions and, if so, whether the acts or omissions constitute violations of NFA Rules. The Counsel to the Panel attends the deliberations to answer any procedural questions that may arise and to understand the substance of the deliberations in order to properly draft the findings and decision. Where the Panel finds that the respondent violated NFA rules, the panel must decide on the appropriate sanction for each violation.

The Counsel for the Panel drafts the decision based upon the Panel's deliberations. Each Panel member then has an opportunity to review and revise the draft before it is finalized. Once finalized, decisions are served on the respondents by certified and regular mail. A copy of each decision is also provided to the Appeals Committee, pursuant to Rule 3-10 (See Section K, below).

J. Sanctions

1. Process

Pursuant to NFA Compliance Rule 3-14, the BCC or Hearing Panel may, at the conclusion of the disciplinary process, impose penalties on respondents found to have violated NFA rules. The potential penalties include: expulsion or suspension from NFA membership; a bar or suspension on associating with an NFA member; censure or reprimand; a monetary fine, not to exceed \$250,000 per violation; an order to cease and desist; or, pursuant to Rule 3-14(a)(vi), "any other fitting penalty or remedial action not inconsistent with" Rule 3-14. NFA staff noted that remedial actions imposed under the "other fitting penalty" rule often include requirements to tape customer solicitations, to pre-file promotional materials, or to obtain sponsor certification. Restitution may be sought in a limited number of cases, and only where customers with losses can be specifically identified.

In cases tried to a Hearing Panel, the NFA team that prepared the case will provide the Panel with a recommendation on sanctions. As noted above, in cases where the respondent makes a settlement offer, the NFA team will provide the BCC or Hearing Panel a recommendation as to whether to accept the offer. NFA staff indicated during our interviews that, in determining such recommendations, they consider the factors discussed in the CFTC policy

guidelines for SRO sanctions,²⁹ such as the seriousness of the offense, the disposition of similar prior cases, customer losses, and respondent's disciplinary history, including actions by NFA, CFTC, other SROs, and other regulatory agencies. NFA staff can access all BCC cases through the Legal Edge database, which allows users to search for cases with certain rule violations and permits other database search functions as well. The Legal Edge database does not, however, provide information regarding the details of the rule violations for these prior cases, such as the customer losses, the respondent's disciplinary history, or specific factors indicating the seriousness of the offense.

In order to determine the extent to which NFA staff documented their rationale for recommending acceptance of a settlement offer, or recommending a particular sanction, Division staff reviewed the memoranda submitted by NFA staff for each of the cases in the sample. Division staff also reviewed the transcripts for the case in the sample which was tried to a Hearing Panel, as well as the transcripts of two cases outside the sample.

2. Division Comments

Division staff found that, in making recommendations for sanctions or for acceptance of settlement offers, NFA staff do not explain how consideration of the relevant factors leads to their recommendation. They do not explain how the sanctions proposed in a case relate to sanctions imposed in comparable previous cases. They do not explain how the proposed penalties relate to customer losses. While our interviews indicate that NFA staff do, in fact, consider these factors in making their recommendations, this consideration is documented, if at all, in only the most conclusory terms.

Failure to document the reasons for recommending a particular level of sanctions in a specific case is unfortunate for three reasons. First, documenting reasons to recommend a specific level of sanctions imposes a discipline on the process that even the most conscientious discussion lacks. Second, documenting the reasons for a particular level of sanctions in one case provides important information for NFA staff to consider in recommending a level of sanctions in future cases. While the participation of experienced staff in such discussions can ameliorate this lack of documentation, such institutional memory can prove ephemeral. Finally, in order to appropriately review NFA's rule enforcement, CFTC staff need to see written evidence of the factors considered.

K. Appeals

NFA Compliance Rule 3-13 provides that a respondent may appeal any adverse decision of the hearing panel to the Appeals Committee by providing notice within 15 days of the decision. The Appeals Committee, which is

²⁹ See *supra*, Note 4.

comprised of a subset of members of NFA's Executive Board, has the discretion to determine that it will review a decision, or may grant a petition for appeal from the Compliance Department. Although staff appeals are rare, they have occurred. NFA staff indicated during interviews that one role of the Appeals Committee is to ensure that different hearing panels do not produce disparate results, although that function may be difficult to fulfill, given the paucity of both appeals and cases decided at hearing.

None of the cases in our sample were appealed during the review period.³⁰

VI. CONCLUSION

NFA treats its responsibilities in the areas of Compliance and Enforcement with a sense of serious purpose and dedication. This sense was demonstrated in the insightful and trenchant reports of the 1997 and 1998 internal studies conducted by NFA on its own initiative. Serious purpose and dedication of the Compliance and Enforcement staff were also evident in the Division's interviews.

NFA's success in finding compliance problems that warrant remediation rather than discipline is thwarted, however, when NFA fails to ensure that those problems have, in fact, been remedied. This is especially true when repetitive problems are found. NFA also needs to ensure that problems which are repeated after a warning are treated more stringently. NFA's resolute pursuit of those members who it determines warrant discipline must be followed by the imposition of appropriate penalties. While these penalties are ultimately determined by the BCC or Hearing Panel, the recommendation of NFA's staff is critically important to the process. To ensure that appropriate penalties are recommended, NFA needs to implement procedures to document its reasons for recommending penalties. NFA should avoid relying on institutional memory to serve this important function.

³⁰ In one case in our sample, NFA requested that the Appeals Committee review a limited portion of the Hearing Panel's decision; the respondent also appealed a portion of the decision. Division staff did not review the details of this appeal since it occurred subsequent to completion of its field work.

VII. Appendix – Recommendations From 1997 And 1998 Internal Reports

In 1997, NFA staff conducted an internal review of the work flow process from the time a matter is first identified in the Compliance Department as a possible BCC referral, through the investigative process and presentation to the BCC. Another NFA team examined the post-complaint portion of the disciplinary process in 1998 to determine how to expedite proceedings from the time the complaint is initiated until any internal appeals are completed and to ensure that sanctions are imposed fairly and consistently in settled cases. These internal reports are thorough, well-supported, and contained useful recommendations for enhancement of the process.

1. 1997 Report of the Legal/Compliance Workflow Team ("LCW")

The LCW's review of NFA's process for investigation and referral for disciplinary action resulted in a number of recommendations, ranging from providing additional training for Compliance and Legal staff members on conducting investigations, to implementation of case management strategies to improve the efficiency of the process. The report recommended creation of the position of Associate General Counsel/Enforcement Coordinator, whose primary role would be to monitor the progress of investigations from the assignment of an attorney through any appeals. NFA appointed an Enforcement Coordinator in May 1998.

Other recommendations included coordinating the scheduling of audits and investigations so that Compliance staff could remain on an investigative team until the investigation is complete; transcribing tape recorded phone conversations and television and radio ads to allow for ease of review; improving access to information resources; assigning an attorney to a case early in the investigative process; and preparing a case summary to communicate to the attorney the Compliance Department's findings and preliminary evidence. The LCW also recommended holding an initial meeting with the General Counsel and Vice President for Compliance to develop a work plan, with interim meetings at the completion of certain mileposts; delineating the responsibility of Compliance and Legal staff regarding drafting and approval of the investigative report; inviting all staff who participated in the investigation to attend the BCC meeting at which the report is presented; providing a draft complaint to the BCC at the meeting; and holding post-investigation meetings to assess the success of the investigation.

Implementation of a number of the recommendations regarding the investigative process is discussed in the earlier sections of this report. In addition, NFA instituted various in-house training sessions dealing with both general and specific issues of the disciplinary process. In October 2000, Division staff attended a training session on the investigative process for Compliance

Department staff. The one-day session, which was conducted by the Enforcement Coordinator, focused on identifying and addressing issues in the audit process that may warrant further investigation, additional steps to take during such audits, interviewing potential witnesses, handling evidence, and involvement in the BCC process.

2. 1998 Report of the Disciplinary Proceedings Innovation Team

This report contained 27 recommendations, dealing primarily with expediting, and increasing the efficiency of, the disciplinary process. With regard to hearing panelists, the report recommended implementing a neutral system for appointing panelists based on availability, paying hearing panelists, using three-person panels for all cases, using hearing officers on a special-needs basis, and providing training for hearing panelists. The report also recommended procedural changes, such as limiting to 30 days the time to file answers; including all cases on the hearing track once an answer is filed, even if the respondent has not requested a hearing; and appointing a chairperson, assigning counsel to the panel, and scheduling a pre-hearing conference as soon as the answer is filed. Other procedural changes, such as selecting the remaining hearing panelists sooner, clarifying the scope of discovery, and strengthening the requirements for continuance requests, were recommended to decrease the amount of time needed to resolve cases. The team also recommended that NFA should adopt sanctions for parties who engage in misconduct during the pre-hearing or hearing stages of the proceeding. With respect to settlements, the team recommended expanding the information and experience relied upon when recommending settlements, including developing a database of settlement, hearing panel and Appeals Committee decisions and investigative reports that can be searched by the Compliance Department and Legal Department.

Several staff indicated in interviews that NFA is currently evaluating the effectiveness of the recommendations that were implemented and plans to issue a report.