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June 25, 2002

Katherine A. England Assistant Director Division of Market Regulation Securities and Exchange Commission 450 Fifth Street, N.W. Washington, D.C. 20549-1001

Re: File No. SR-NASD-2002-40, Amendment No. 1 – Security Futures Rules

Dear Ms. England:

Pursuant to our conversations with the staff of the Division of Market Regulation, NASD hereby submits Amendment No. 1 to SR-NASD-2002-40 (the "rule filing"). The following changes should be made to the rule filing.

1. The "Registered Options and Security Futures Principals" section in proposed Rule 1022(f)(6) beginning on pages five and sixty-four of the rule filing should be revised to read as follows (new language is indicated with <u>double underline</u>):

(5)[(6)] Any person who is registered with NASD as a Registered Options and Security Futures Principal may not supervise security futures activities unless such person has, prior to December 31, 2008, completed a firm-element continuing education requirement that addresses security futures and a principal's responsibilities for security futures. After a revised examination that includes security futures products is offered, a person associated with a member that passes such a revised Qualification Examination for Registered Options and Security Futures Principal (or any other examination covering security futures that is acceptable to NASD) is not required to complete a firm-element continuing education requirement that addresses security futures and a principal's responsibilities for security futures to supervise activities in such products, except as otherwise required by Rule 1120 generally or by the member firm.

2. Rule 1022(g)(3) beginning on pages five and sixty-five of the rule filing should be revised to read as follows (new language is indicated with <u>double underline</u>):

(g)(3) Any person who is registered with NASD as a Limited <u>Principal</u>—General Securities Sales Supervisor may not act in a limited principal capacity with regard to security futures products unless such person has, prior to <u>December 31, 2008, completed a firm-element continuing education requirement that</u> addresses security futures and a principal's responsibilities for security futures. After a revised examination that includes security futures products is offered, a person associated with a member that passes such a revised Qualification Examination for Limited Principal—General Securities Sales Supervisor (or any other examination covering security futures that is acceptable to NASD) is not required to complete a firm-element continuing education requirement that addresses security futures and a principal's responsibilities for security futures to supervise such products, except as otherwise required by Rule 1120 generally or by the member firm.

3. The "General Securities Representative" section in proposed Rule 1032(a)(2)(E) beginning on pages 8 and sixty-eight of the rule filing should be revised to read as follows (new language is indicated with <u>double underline</u> and deleted text is indicated with strikethrough):

(2)(E) A person who is registered with NASD as a General Securities Representative may not act as a General Securities Representative with regard to security futures products unless such person has, prior to December 31, 2008, completed a firm-element continuing education requirement that addresses security futures products. After a revised new examination or module that includes security futures products is offered, a person associated with a member who passes such a revised Qualification Examination for General Securities Representative (or any other examination covering security futures that is acceptable to NASD) is not required to complete a firm-element continuing education requirement that addresses security futures to act as a General Securities Representative with regard to such products, except as otherwise required by Rule 1120 generally or by the member firm. Once the new a revised examination or module that includes security futures becomes available, persons seeking to become a General Securities Representative will be required expected to pass such revised examination (or any other examination covering security futures that is acceptable to NASD) to act as a General Securities Representative with regard to security futures products. Only persons registered as a General Securities Representative prior to the time that the new such revised examination or module is available will be eligible to use a firm-element continuing education program in lieu of passing the new examination to engage in a security futures business.

4. The Limited Representative—Options and Security Futures section in proposed Rule 1032(d)(4) beginning on pages ten and sixty-nine of the rule filing should be revised to read as follows (new language is indicated with <u>double underline</u>):

(4) <u>Any person who is registered with NASD as a Limited</u> <u>Representative—Options and Security Futures may not act as a limited representative</u> <u>with regard to security futures products unless such person has, prior to December 31,</u> <u>2008, completed a firm-element continuing education requirement that addresses</u> Katherine A. England, Assistant Director June 25, 2002 Page 3

security futures. After a revised examination that includes security futures products is offered, a person associated with a member who passes such a revised Qualification Examination for Limited Representative—Options and Security Futures (or any other examination covering security futures that is acceptable to NASD) is not required to complete a firm-element continuing education requirement that addresses security futures to act as a limited representative with regard to such products, except as otherwise required by Rule 1120 generally or by the member firm.

5. Rule 1060 "Persons Exempt from Registration" should be added to the rule filing immediately following Rule 1032(h), beginning on pages ten and seventy. The rule filing should be revised to read as follows:

1060. Persons Exempt from Registration

* * *

(4) persons associated with a member whose functions are related solely and exclusively to:

(A) effecting transactions on the floor of a national securities exchange and who are registered as floor members with such exchange;

(B) transactions in municipal securities; [or]

(C) transactions in commodities; or

(D) transactions in security futures, provided that any such person is registered with a registered futures association.

6. Language setting forth the purpose of Proposed Rule 1060 "Persons Exempt from Registration" should be added to the rule filing immediately before "4. Short Sale Restrictions", beginning on pages fifty-three and 112. The rule filing should be revised to read as follows (new language is indicated with <u>double underline</u>):

As an alternative to continuing education, or because registered personnel will be expanding the scope of their securities business, we anticipate that certain existing registrants may take revised qualification examinations covering security futures. NASD has modified the registration categories to provide it with the flexibility to accept, for certain registration categories, other examinations that address security futures. For example, if a person has passed the Series 7 and subsequently takes the revised Series 3 (containing questions on security futures), we do not believe that it should be necessary for such person to complete a firm-element continuing education program as a prerequisite to engaging in a security futures business. In that case, the successful completion of the revised Series 3 demonstrates proficiency in security futures products. Once revised examinations are developed, NASD will announce in a Notice to Members or other publication the examinations that can be used to demonstrate proficiency in security futures for each registration category. In response to the SEC staff's request that NASD establish a sunset date, NASD has selected December 31, 2008 as a sunset date for the continuing education provisions. After that date, registrants who have passed a qualifications examination that does not include security futures, and who have not already completed a firm-element continuing education program on security futures, will be required to retake an examination to function in a registration category with respect to security futures.

In addition, NASD has amended Rule 1060(a) to exempt from registration with NASD persons associated with a member whose functions are related solely and exclusively to transactions in security futures, provided that such persons are registered with a registered futures association. The proposed rule change recognizes that certain persons in a firm that is fully registered as a broker/dealer and either an FCM or IB, who presently engage solely in a commodities business, will seek to expand their activities into security futures. The proposed rule change is necessary to avoid having such persons be required to register with NASD as a representative. NASD believes that so long as such individuals are registered with a registered futures association, and such persons' securities activities are limited solely to security futures, there should be no additional requirement for such persons to register with NASD. As a result of this change, for example, a person who is a Series 3 registered person with the NFA will not be required to take the Series 7 or Series 62 simply because such person intends to engage in a security futures business.

7. There are typographical errors in Rule 3370 on pages forty-nine and 108 of the rule filing. The word "advisements" was inadvertently used in place of the correct term "advertisements". The rule filing should be revised to read as follows (new language is indicated with <u>double underline</u> and deleted text is indicated with strikethrough):

Contrary to the requirement that a principal approves advertisements and sales literature under Rule 2210(b), however, the proposed rule specifies that advisements <u>advertisements</u> and sales literature concerning security futures must be approved by a Registered Options and Security Futures Principal (Series 4). In particular, a General Securities Principal (Series 24) is not authorized to approve advertisements and sales literature concerning security futures.

8. The "Trading Ahead of Customer Orders" section in proposed Rule 2865(b)(25) beginning on pages thirty-five and ninety-four of the rule filing should be revised to read as follows (new language is indicated with <u>double underline</u> and deleted text is indicated with strikethrough):

<u>Every member shall exercise use due care to avoid trading ahead of a</u> customer's security futures order that is executable at or near the market price. A member must transmit a security futures customer order that is executable at or near the market price to a securities exchange or a notice registered securities exchange before it transmits any order in the same security future for any proprietary account, or for any account in which it or any person associated with it is directly or indirectly interested. A member must exercise the due care required by this subsection when the member has gained knowledge of or reasonably should have gained knowledge of the customer's order prior to the transmission to a securities exchange or a noticeregistered securities exchange of the member's order for a proprietary account, or for any account in which it or any person associated with it is directly or indirectly interested.

9. Language setting forth the purpose of Proposed Rule 2865(b)(25) "Trading Ahead of Customer Orders" beginning on pages forty-eight and 107 should be revised to read as follows (new language is indicated with <u>double underline</u> and deleted text is indicated with strikethrough):

Trading Ahead

The proposed rule change requires members to exercise due care to avoid trading ahead of customer orders <u>in the same security futures contract</u>. The proposed provision imposes an obligation on members not to trade ahead of customer security futures orders executable at or near the market price in a proprietary account or in any account in which the member or an associated person has an interest. The prohibition against trading ahead applies only to customer orders of which the member is aware or reasonably should be aware. This proposed provision is based on the rules that FCMs and IBs must follow regarding trading security futures ahead of customer orders.⁺

This provision is based on the NFA's Interpretive Notice regarding obligations to customers and other market participants.¹³ The NFA's Interpretive Notice gives two examples of when a firm would reasonably not be aware of a customer's order: (1) when a customer's order originates in a different branch office than the firm's proprietary order, and (2) when the firm's trading department does not have access to information about customer orders. We believe that these two situations are also examples of when a firm would not violate the proposed NASD rule. Moreover, these two examples are not exhaustive. We anticipate that there are additional situations in which a firm reasonably would not be aware of a customer's order to a securities exchange before a customer's order. We cannot enumerate all such situations at this time because, among other things, they may depend on the trading rules of a securities exchange that trades security futures.

¹ <u>See NFA Rule 2-26; CFTC Regulations 155.3 & 155.4.</u>

¹³ National Futures Association Manual, ¶ 9041 (Vol. 7, No. 2 2001); <<u>www.nfa.futures.org/compliance/manual/M11Interp_41.html</u>>.

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10. The first paragraph of the "Qualifications of Registered Persons" section beginning on pages fifty-one and 110 of the rule filing should be revised to read as follows (new language is indicated with <u>double underline</u> and deleted text is indicated with strikethrough):

3. Qualifications of Registered Persons

The securities industry has a wide array of qualification examinations that registered persons can take to qualify to engage in various aspects of the securities business. To accommodate the introduction of security futures, we propose a rule change to modify several registration categories. In general, where a registration category permits an individual to engage in an options business, we have modified the category to permit security futures. As part of this change, NASD is working with other self-regulatory organizations to develop <u>new and</u> revised qualification examinations that will test applicants on security futures-related topics. We anticipate that the <u>new and</u> revised qualification examinations will be completed by the end of the third quarter of 2002 six months after retail trading in security futures commences.

11. Footnote nineteen at the bottom of page fifty-two of the rule filing should be revised to read as follows (new language is indicated with <u>double underline</u> and deleted text is indicated with strikethrough):

Specifically, a for the Series 43 examination 7, will be offered for registered representatives seeking to engage in a security futures business. Once the Series 43 is developed separate module is available, new applicants seeking to act as a general securities representative may choose to take either the only the Series 7, or, if they intend to engage in a security futures business, the Series 7 and Series 43 examinations, and the security futures model or only the Series 7. After the Series 43 examination is developed, Ppersons taking only the Series 7 will not be permitted to engage in a security futures business. Completing a firm-element continuing education program will be an option available only for persons who are registered as a general securities representative before the separate Series 43 examination securities futures module becomes available.

12. Finally, since the initial filing date, NASD has undergone a corporate reorganization and name change. We now wish to be known as "NASD." Please replace all references to "NASD Regulation," "the Association" and "the NASD" in the purpose section of the rule filing and in the text of the proposed rule change with "NASD." We have made the necessary changes in items 1-11 above. Please do not change references to these terms in sections of NASD rules that are not amended by the proposed rule change but are nonetheless included in the filing to help readers understand the context of the proposed rule change. Changes to terms in these sections will be made in a separate filing at a later date.

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If you have any questions concerning this amendment, please contact Gary L. Goldsholle, Office of General Counsel, NASD, at (202) 728-8104; e-mail gary.goldsholle@nasd.com. The fax number of the Office of General Counsel is (202) 728-8264.

Very truly yours,

Patrice M. Gliniecki Vice President and Deputy General Counsel