

April 1991

# FUTURES MARKETS

## Strengthening Sales Practice Oversight



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United States  
General Accounting Office  
Washington, D.C. 20548

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General Government Division

B-236445

April 25, 1991

The Honorable Patrick J. Leahy  
Chairman, Committee on Agriculture,  
Nutrition, and Forestry  
United States Senate

The Honorable E (Kika) de la Garza  
Chairman, Committee on Agriculture  
House of Representatives

The Honorable Glenn English  
Chairman, Subcommittee on Conservation,  
Credit and Rural Development  
Committee on Agriculture  
House of Representatives

This report contains our evaluation of Commodity Futures Trading Commission oversight of self-regulatory organization monitoring and enforcement of sales practice compliance among futures industry firms. We did the work under our basic statutory authority in response to congressional concerns over the protection afforded investors in the futures market. We are also sending copies of our report to the Commodity Futures Trading Commission, other interested Members of Congress, appropriate committees, and the public.

Major contributors to this report are listed in appendix III. Please contact me on (202) 275-8678 if you or your staff have any questions concerning this report.

A handwritten signature in cursive script that reads 'Craig A. Simmons'.

Craig A. Simmons  
Director, Financial Institutions  
and Markets Issues

# Executive Summary

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## Purpose

Immediately following the market crash of 1987 and more recently, a number of concerns have been raised about the protection afforded investors in the nation's financial markets, including those in which financial futures are traded. Because of this increasing concern over the protection afforded investors, GAO evaluated federal oversight of industry self-regulation of sales practices in the commodity futures market by reviewing CFTC's oversight of SRO compliance with sales practice requirements and its monitoring of SRO sales practice audits.

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## Background

U.S. futures exchanges and the National Futures Association (NFA), designated as SROs under the Commodity Exchange Act, are responsible for enforcing member firms' compliance with industry standards for marketing and selling futures products to the public. CFTC oversees SRO enforcement of sales practice standards both to ensure the integrity of the self-regulatory process and to protect investors from sales practice abuse.

According to CFTC, its program to accomplish its sales practice oversight objectives is multifaceted, involving numerous programs, and integrated. In addition to oversight of SRO sales practice audits and SRO compliance with sales practice requirements—the programs that GAO reviewed—CFTC's programs include enforcement actions to achieve customer protection and sales practice compliance; registration, sponsorship and competency testing of sales professionals; consumer education; maintenance of a reparations system for customer redress; and general rulemaking activities.

SROs establish minimum standards of conduct and fair practice by adopting membership rules—rules that CFTC must review and approve. Under CFTC regulations and NFA rules, all firms that sell futures must belong to NFA and many firms are also members of at least one exchange. Under the Commodity Exchange Act, SROs are to investigate alleged rule violations by their members and discipline members who violate the rules. Disciplinary actions may include warning letters, fines, suspensions, or expulsions.

Exchange members include futures commission merchants—the general equivalent to a securities broker-dealer. A futures commission merchant is an individual or firm that solicits or accepts orders from the public for buying or selling commodity futures or options contracts and that accepts payment from, or extends credit to, those whose orders are accepted.

CFTC has established minimum requirements for SRO sales practice programs, including sales practice audits of member firms to test compliance with SRO rules. CFTC periodically reviews SRO programs for compliance with its requirements and for SRO enforcement of SRO rules.

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## Results in Brief

CFTC's oversight of futures industry sales practices needs to be strengthened to provide investors with additional protection against sales practice abuse. Improvements are needed in CFTC reviews of SROs, CFTC oversight of SRO member firm audits, and industry regulation of excessive sales commissions. Specifically, the following areas need attention:

- CFTC reviews of SROs provide limited coverage of compliance with sales practice requirements and could be better planned and documented; also, CFTC does not always either resolve disagreements with SROs over review recommendations for sales practice program improvements or use its legal and regulatory authority to require SROs to adopt them.
- CFTC does not provide regular monitoring of SRO sales practice audit compliance or results, and CFTC has not enforced its audit requirements.
- The futures industry lacks a rule—similar to rules in the securities industry—requiring fair and reasonable commission charges. Recent cases of alleged abuse that also involved excessive commissions support the need for such a rule.

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## Principal Findings

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### CFTC Reviews Can Be Improved

CFTC does on-site reviews of each SRO, called rule enforcement reviews, to assess compliance with SRO sales practice rules and CFTC regulations. CFTC, however, did not review SRO compliance with an average of 10 of 21 sales practice requirements at each SRO reviewed from October 1986 to September 1989. GAO identified these requirements from CFTC regulations and formal guidance to SROs. Several CFTC sales practice requirements, including proper controls over the receipt of customer complaints, were either not covered by CFTC reviews or covered at only one SRO during the period. Also, CFTC had no standardized guidelines for conducting sales practice reviews. Such guidelines, which CFTC has for its financial reviews of SRO programs, could require standard testing procedures and complete coverage of all program areas. (See pp. 13-19.)

Further, CFTC does not always resolve disagreements or ensure that SROs adopt recommendations made as a result of these reviews. For the 10 reviews GAO examined, instances were noted in which CFTC repeated recommendations made in previous reports. For example, an exchange did not agree to improve investigative procedures until CFTC recommended three times that it do so. Improving CFTC reviews could provide better assurance that SROs adequately monitor members' sales practices. (See pp. 19-20.)

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### CFTC Oversight of SRO Audits Can Be Improved

CFTC requires SROs to conduct annual sales practice audits of member firms to assess compliance with industry sales practice rules and regulations. However, CFTC needs to improve its oversight of SRO audit compliance. GAO found that (1) CFTC does not monitor SRO compliance with audit requirements or SRO audit results between rule enforcement reviews, (2) CFTC sales practice audit requirements are not enforced and allow firms to have no branch offices audited, and (3) an SRO audit program used to audit member firm sales practices is incomplete.

GAO found that 80 futures commission merchants, representing 22 percent of these firms, have not received regular full-scope audits in compliance with CFTC's sales practice audit requirement, and another 103 futures commission merchants, or 28 percent of these firms, have not received complete audits covering both options and futures sales practice compliance. CFTC enforcement of audit requirements and improvements to the SRO audit program could provide additional assurance that industry firms comply with sales practice rules and regulations. (See pp. 23-31.)

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### No Industry Rule on Fair and Reasonable Commissions

CFTC recently accused two firms of defrauding customers resulting in customer losses of more than \$460 million over 5 years. CFTC's complaints allege that the firms charged customers high commissions. The total commissions charged by the two firms was \$323 million. Neither NFA nor the exchanges, however, have specific rules defining or prohibiting excessive commissions. Such rules already exist in the securities industry to deter abuse. Instead of regulating commissions to protect investors, futures SROs require firms to disclose all charges and rely on the customer to determine what is reasonable. (See pp. 33-35.)

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## Recommendations

GAO makes several recommendations to the Chairman, CFTC, related to

- developing standardized sales practice review guidelines to provide detailed guidance on conducting rule enforcement reviews and to ensure coverage of all sales practice requirements (see p. 20),
- requiring either the resolution of disagreements over review recommendations or the use of its legal and regulatory authority to require SROs to adopt recommendations for program improvements made as a result of rule enforcement reviews (see p. 20),
- improving compliance monitoring and enforcement of sales practice audit requirements (see pp. 31-32), and
- requiring the futures industry to adopt a rule requiring fair and reasonable commissions (see p. 36).

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## Agency Comments and GAO's Evaluation

CFTC said that it plans to improve its sales practice oversight program in general and in response to GAO's report. It also said that it is committed to making additional changes whenever it is convinced that such changes would further improve the program. However, in this regard, it expressed reservations about some of GAO's observations and recommendations on the basis of its belief that GAO's report reflected a misunderstanding of the integrated nature of its multiprogram regulatory scheme. It pointed out that SRO sales practice audits are only one component of its multiprogram approach and said that no one program in and of itself would be sufficient to deter sales practice abuses.

GAO believes that CFTC misunderstood the purpose of GAO's review and consequently took GAO's findings and recommendations out of the context intended. GAO's purpose was to do a compliance review of one component of CFTC's multiprogram approach—the component directly related to sales practice oversight—to determine how well that component was complying with established CFTC procedures. GAO's logic in doing so was that if one of the components was not functioning as intended, the synergistic benefits from the multiprogram approach would not accrue as CFTC expected. CFTC's comments and GAO's responses are in the appropriate chapters and in appendix II.

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**Abbreviations**

CBT	Chicago Board of Trade
CFTC	Commodity Futures Trading Commission
CME	Chicago Mercantile Exchange
COMEX	Commodity Exchange, Incorporated
FCM	futures commission merchant
MSRB	Municipal Securities Rulemaking Board
NASD	National Association of Securities Dealers
NFA	National Futures Association
NYSE	New York Stock Exchange
RER	rule enforcement review
SRO	self-regulatory organization

# Introduction

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Immediately following the market crash of 1987 and more recently, a number of concerns have been raised about the protection afforded investors in the nation's financial markets, including those in which financial futures are traded. Because of this increasing concern over the protection afforded investors, GAO evaluated federal oversight of industry self-regulation of sales practices in the commodity futures market by reviewing CFTC's oversight of SRO compliance with sales practice requirements and its monitoring of SRO sales practice audits.

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## Background

Over 300 million commodity futures contracts, including options on futures contracts, were traded in the United States during fiscal year 1989. A futures contract is a binding agreement between two or more parties for the delivery of a commodity in a quantity, on or before a date, and at a price, each specified at the time the contract is executed. Both parties to the contract are obligated to perform, which can take the form of physical delivery of the commodity, cash settlement, or offsetting transactions.<sup>1</sup> Futures contracts cover such diverse commodities as grain, precious metals, currency, and government securities. In contrast, a commodity futures option gives the buyer the right, but not the obligation, to buy or sell a futures contract. For this right, the buyer pays the seller a premium.

Risks investors, including commodity futures investors, face include both market risk and potential fraudulent or unethical sales practices. Market risk includes the possibility of significant price volatility resulting from many unpredictable factors, such as weather, labor actions, economic news, and political events. Investors may also be subject to fraudulent or unethical sales practices including high-pressure sales tactics that emphasize the potential for great profit without any disclosure of the risk. These tactics may induce unwary investors to make unsuitably risky investments or to invest when little or no opportunity for profit exists. We were unable to obtain firm estimates of the number of retail customers that, according to CFTC officials, are the most subject to this type of abuse. CFTC and SRO officials told us that they consider the number to be relatively small compared to the total number of market participants.

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<sup>1</sup>An offsetting transaction is the purchase or sale of an equal number of futures contracts of the same delivery month to cancel the original contracts sold or purchased, respectively.

CFTC, an independent federal agency created by Congress in 1974, is responsible for overseeing customer protection in the sales of commodity futures. CFTC oversees a market that is principally regulated by SROs, which include the 14 U.S. futures exchanges and the National Futures Association (NFA). CFTC is responsible for encouraging market competition and efficiency, ensuring market integrity, and protecting market participants from manipulation, fraud, and abuse.

CFTC oversees SRO enforcement of sales practice standards through a multiprogram integrated approach both to ensure the integrity of the self-regulatory process and to protect investors from sales practice abuse. In addition to its oversight of SRO sales practice audits and SRO compliance with sales practice requirements—the programs that we reviewed—CFTC meets its sales practice oversight objectives by prosecuting enforcement cases to deter and punish sales practice violations and other violations of the Commodity Exchange Act and regulations; maintaining a customer reparations forum, which provides an avenue of redress for sales practice and other complaints against commodity professionals; overseeing the registration of commodity professionals by NFA; and adopting rules as necessary to address generalized problems. The Commodity Exchange Act also requires CFTC to review, approve, or permit to go into effect all rules of conduct that SROs propose. Within CFTC, since about 1982, the Division of Trading and Markets has monitored the sales practice rule enforcement and compliance activities of futures SROs.

SROs are private membership organizations given the power and responsibility under the Commodity Exchange Act and federal regulations to adopt and enforce rules of member conduct. Exchange membership includes futures commission merchants (FCM)—the general equivalent to the broker-dealer in the securities markets. An FCM is an individual or firm that solicits or accepts orders from the public for buying or selling commodity futures contracts and that accepts payment from, or extends credit to, those whose orders are accepted. Under the act, SROs are to investigate alleged rule violations by their members and discipline members who violate the rules. Disciplinary actions available to SROs may include warning letters, fines, suspensions, or expulsions.

CFTC, in a Sales Practice Audit Interpretation issued December 16, 1986, established minimum requirements for SRO sales practice programs, including requirements for the frequency and coverage of SRO sales practice audits of member firms. According to CFTC, sales practice audits are essential components of SRO oversight programs and are used to test

member firm programs for compliance with SRO rules. Such audits, together with investigatory, enforcement, and customer redress procedures, help to deter and detect customer abuse. CFTC's Division of Trading and Markets staff conduct rule enforcement reviews (RER) to evaluate the effectiveness of SRO programs for enforcing compliance with SRO rules and CFTC regulations. CFTC staffed its sales practice oversight program during the period covered by our review with one attorney supervisor and three futures trading specialists, two of whom were located in Chicago.

NFA is the only futures association registered with CFTC under the Commodity Exchange Act. Section 17 of the act authorizes the creation of, and prescribes registration standards for, futures associations that have explicit self-regulatory obligations under the act and CFTC regulations. CFTC registered NFA as a futures association to establish minimum industry sales practice standards and a comprehensive program to implement these standards. Under CFTC regulations and NFA rules, all firms that sell futures products must belong to NFA, including exchange member firms.<sup>2</sup> NFA members include commodity exchanges, FCMS, introducing brokers,<sup>3</sup> commercial firms, and banks. In addition to sales practice audit responsibility common to all SROs, NFA responsibilities include registering commodity futures firms and professionals<sup>4</sup> and establishing minimum industry standards governing training, proficiency, and sales practices to ensure high standards of professional conduct and to protect the public.

## Objectives, Scope, and Methodology

Our primary objective was to evaluate CFTC oversight of SRO monitoring and enforcement of futures industry sales practice rules and regulations.<sup>5</sup> To do so, we evaluated the coverage and adequacy of CFTC RERS of SRO sales practice programs and assessed CFTC monitoring of SRO compliance with its requirements for sales practice audits of industry firms. In

<sup>2</sup>Most industry firms belong to NFA, but many NFA member firms do not belong to an exchange. NFA was created, in part, to provide oversight for those firms that did not belong to an exchange and were therefore not subject to exchange supervision. However, NFA articles and rules were specifically amended to make clear that they would not be preempted by exchange rules.

<sup>3</sup>An introducing broker is any person engaged in soliciting or accepting orders for the purchase or sale of a commodity for future delivery on an exchange who does not accept any money, securities, or property to margin, guarantee, or secure any trade or contract that results from the order.

<sup>4</sup>Industry professionals are those persons employed by NFA member firms who must be registered with NFA; they are also referred to as associated persons.

<sup>5</sup>See related GAO report on the Securities and Exchange Commission entitled Securities Industry: Strengthening Sales Practice Oversight (GAO/GGD-91-52, April 1991).

addition, because of recent CFTC allegations of fraud at firms that also charged high commission rates, we assessed the need for an industry rule to require fair and reasonable sales commissions. We did not review CFTC's management of other sales practice-related programs such as its enforcement, reparations, or registration programs. We limited our review to CFTC's direct oversight of SRO sales practice program compliance.

To evaluate the coverage and adequacy of CFTC RERS of SRO sales practice programs, we reviewed the 10 sales practice RERS the agency issued from October 1986 through September 1989, for coverage of CFTC sales practice requirements. We identified these requirements from CFTC guidance to SROs and CFTC regulations. (See app. I.) We also reviewed CFTC follow-up on the resolution of recommendations made during previous RERS. Our review period began in October 1986 because CFTC issued sales practice program guidance to the SROs in late 1986. We gave CFTC credit for coverage of a requirement at an SRO for the entire 3-year period if one or more RER reports on that SRO made any reference to compliance with that requirement.

We also traced the contents of 4 of the 10 RER reports to CFTC's supporting evidence to assess the quality of documentation and support for conclusions. For this purpose, we selected the most recent RERS of the three largest SROs—NFA, the Chicago Board of Trade (CBT), and the Chicago Mercantile Exchange (CME)—and those of one smaller SRO—the Commodity Exchange, Inc. (COMEX). We selected recent reviews to ensure that RER documentation would still be available and the reviews would reflect current practices.

To evaluate CFTC oversight and SRO sales practice audit coverage, we analyzed CFTC's sales practice audit requirements, compared the audit guidelines used by SROs with CFTC's sales practice requirements, and reviewed the delegation of audit responsibility among the SROs when firms were members of more than one exchange. To assess CFTC enforcement of its audit requirements, we analyzed the audit completion statistics of NFA, CBT, and CME for calendar years 1987 and 1988. At the time of our review, these years represented the most recently completed time periods covered by CFTC's audit requirements. We selected these SROs because they are responsible for conducting over 70 percent of the sales practice audits that CFTC requires. We relied on computer-generated lists of SRO member firms and branch offices supplied by NFA and did not verify their reliability. We did limited work to verify the reliability of audit completion data that SROs submitted and found no discrepancies.

To assess the need for an industry rule related to sales commissions, we reviewed CFTC RER reports and federal civil court charges associated with two firms alleged to have defrauded customers using high-pressure sales tactics while charging high commissions. We also reviewed rules related to sales commissions in the stock and municipal securities industries. We did not attempt to review the effectiveness of these rules but did determine whether enforcement actions had been taken.

Finally, at CFTC's Washington, D.C., headquarters, we interviewed officials of the Division of Trading and Markets, Division of Enforcement, and Office of the General Counsel to discuss agency monitoring of SRO sales practice programs. In Chicago, we interviewed officials of the CFTC Chicago Regional Office, CBT, CME, and NFA to discuss CFTC oversight and self-regulation of industry sales practice standards.

We also reviewed provisions of the Commodity Exchange Act, CFTC regulations, and SRO rules to identify authority and responsibility for enforcing industry sales practice standards.

A copy of the draft of this report was sent to CFTC for comment. CFTC's comments on the draft were received in a letter from the CFTC chairman dated December 6, 1990 (see app. II). We did our field work between January 1989 and June 1990 in accordance with generally accepted government auditing standards.

# CFTC Sales Practice Rule Enforcement Reviews Need Improvement

According to CFTC Division of Trading and Markets officials, periodic sales practice RERs are CFTC's principal routine method of overseeing SRO sales practice programs. We found, however, that RERs provide only limited coverage of sales practice requirements and could be better planned and documented. The lack of a standardized guide for conducting sales practice RERs, similar to the one used for SRO financial programs,<sup>1</sup> has contributed to these problems. In addition, CFTC does not always either resolve disagreements with SROs over RER recommendations for sales practice program improvements or use its legal and regulatory authority to require SROs to adopt recommendations. As a result, CFTC reviews do not fully evaluate SRO sales practice program compliance or ensure that needed program improvements are made.

## CFTC Does Periodic RERs

Since 1983, CFTC has conducted a sales practice RER of each SRO on an average of about once every 2.3 years.<sup>2</sup> The time elapsed between CFTC reviews of SRO sales practice compliance ranged from about 1 year to over 5 years. According to CFTC officials, the agency's goal is to conduct sales practice RERs of the large SROs regularly and to conduct RERs of the other SROs whenever possible. The SROs with the most futures commission merchants (FCM) assigned to them for audit—CBT, CME, NFA, and the New York Futures Exchange—were reviewed more frequently, on average about once every 2.1 years. Depending on the deficiencies noted during an RER, CFTC may also conduct a follow-up review to test SRO resolution of deficiencies. As of December 31, 1989, CFTC had issued reports on 20 RERs of 10 SROs' sales practice programs and on 10 follow-up reviews.

## RERs Do Not Address Compliance With All Sales Practice Requirements

We reviewed CFTC formal guidance to SROs and federal regulations and identified 21 sales practice-related requirements for SRO audits of member firms. Our review of RER reports issued from October 1986 through September 1989, however, showed that CFTC did not check each SRO's compliance during this period with an average of 10 of the 21 requirements. In addition, CFTC did not check for the resolution of audit deficiencies found at member firms for four of the seven SROs CFTC reviewed during the period. As a result of this lack of coverage, CFTC

<sup>1</sup>Financial RERs cover SRO compliance with CFTC financial-related standards and are done within the Division of Trading and Markets. CFTC requires the SROs to conduct financial audits to verify firm compliance with minimum capital and reporting requirements.

<sup>2</sup>This average is based on the dates the reports were issued and excludes three RERs of SROs that no longer have sales practice responsibility.

cannot ensure that it is detecting noncompliance with all of its requirements or that SRO audits adequately assess compliance with industry sales practice standards. As discussed in the following text, the absence of a systematic approach to planning RERS contributes to the lack of coverage these requirements received.

We identified most of the sales practice requirements from CFTC's Sales Practice Audit Interpretation, which was issued in 1986 and contains guidance for SROs to follow in conducting sales practice audits of their member firms.<sup>3</sup> According to the interpretation, the responsible SRO must do a sales practice audit of each member firm and a selected number of branch offices every year. The interpretation also includes general requirements that SRO audits of member firms be adequately staffed, well planned, and fully documented. These are similar to several generally accepted government auditing standards.<sup>4</sup> Finally, CFTC's guidance requires that specific components of member firm sales practice programs be reviewed during each SRO audit of a member firm. These components include (1) registration, supervision, and training of sales personnel; (2) control and resolution of customer complaints; (3) adequacy of sales operations of branch offices; (4) controls over discretionary accounts;<sup>5</sup> and (5) disclosures to customers. Federal regulations also contained requirements for audits of options sales practices in 17 C.F.R. 33 that were included in our list of requirements. (See app. I for a description of each requirement and its source.)

Table 2.1 shows the number of requirements CFTC did not cover for each SRO receiving an RER from October 1986 through September 1989.

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<sup>3</sup>The interpretation requirements are not CFTC-approved rules. Instead they are practices that the CFTC Division of Trading and Markets follows in administering the Commodity Exchange Act and CFTC regulations.

<sup>4</sup>Generally accepted government auditing standards are published in Government Auditing Standards: Standards for Audit of Governmental Organizations, Programs, Activities, and Functions, GAO (Washington, D.C.: GPO, 1988 revision).

<sup>5</sup>A discretionary account is an account in which the customer has given a broker the power to place buy or sell orders for the account without the customer's prior approval.



**Chapter 2**  
**CFTC Sales Practice Rule Enforcement**  
**Reviews Need Improvement**

**Table 2.1: Number of Sales Practice Requirements CFTC Did Not Cover at Each SRO**

SRO	Number of	
	RERs in period	Requirements not covered
CBT	3	6
CME	2	6
COMEX	1	13
Kansas City Board of Trade	1	9
New York Futures Exchange	1	14
New York Mercantile Exchange	1	12
NFA	1	8
<b>Total</b>		<b>68</b>

Source: GAO prepared the table on the basis of an analysis of CFTC RER reports.

As shown by the differing numbers of requirements not covered at each exchange, CFTC covered requirements at some SROs that were not covered at others. Out of the 21 requirements, 15 were not covered by CFTC at one or more SROs during the period we examined. Of these requirements, six received almost no coverage by CFTC at any SRO during the period. These six included requirements that the SROs review (1) the proper registration of firm employees,<sup>6</sup> (2) member firm controls over incoming correspondence for identification of customer complaints, (3) the backgrounds of the SRO auditors for possible conflicts of interest, (4) documentation of corporate accounts for proper trading authorizations, (5) personal accounts of member firm employees for trading violations, and (6) sales of deep out-of-the-money options<sup>7</sup> for abuses. For example, CFTC guidance requires that SRO audits test to ensure adequate procedures for the receipt and identification of customer complaints; however, CFTC did not address compliance with this requirement in any RER report. CFTC officials told us that RER coverage was often limited to only specific issues and that RER reports may not have documented all issues reviewed. As discussed in the following section, RER workpapers that we reviewed not only showed no evidence of additional work not covered in the reports but also showed no support for some report statements.

<sup>6</sup>Federal regulations and NFA rules require employees of NFA member firms to be registered under the Commodity Exchange Act. NFA's registration screening process includes a background check to identify any past SRO rule violations or criminal record. NFA can deny or restrict registration if applicants do not meet standards set forth in the act. The act also prohibits employees from soliciting or accepting customer orders without proper registration.

<sup>7</sup>A deep out-of-the-money option has an exercise price far from the current market price of the underlying futures contract and thus has little market value.

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## RERs Could Be Better Planned and Documented

As discussed in the previous section, CFTC's sales practice interpretation includes requirements for planning and documenting sales practice audit work done by SROs. However, without standardized guidelines for conducting RERs of SRO sales practice programs, CFTC has no documented systematic method to assess compliance with these requirements. In addition, CFTC does not gather audit compliance data between RERs to help identify problems that could be used in planning future RERs. Finally, we found that RER report documentation contained little or no support for many report statements and that available evidence contradicted many other report statements. In one instance, this resulted in CFTC not identifying and addressing an SRO's noncompliance.

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## RER Guidelines Do Not Exist and Audit Data Are Not Gathered to Assist Planning

CFTC planning for sales practice RERs could be improved if the agency prepared standardized guidelines and gathered data on SRO audit results between RERs. Written guidelines could help ensure complete and consistent coverage of SRO compliance with each sales practice requirement and could document CFTC institutional knowledge of sales practice oversight. Regular review and analysis of SRO audit results could help CFTC identify SRO activities in need of coverage during an RER.

Generally accepted government auditing standards include requirements similar to those CFTC has for its SROs related to audit planning. According to these standards, planning is needed to develop audit objectives, criteria for assessing performance, and audit programs to guide the work. Audit programs or guidelines should include specific audit steps describing the audit testing procedures needed to accomplish audit objectives. Standardized guidelines and data analysis in support of RER planning could help CFTC ensure that review objectives are achieved.

CFTC planning for a sales practice RER is usually limited to preparing a list of areas to cover during each review. The CFTC Chicago regional office has prepared an oversight manual and a series of standardized guides for conducting financial RERs, but similar guidance has not been prepared for conducting sales practice RERs. The financial manual includes standardized guides that provide specific procedures for testing SRO compliance with financial requirements during on-site reviews. CFTC officials responsible for sales practice RERs told us that they rely on institutional knowledge and a review of customer complaints to prepare for and conduct RERs. They said the same few people have done each sales practice RER since the program began. Without a standardized guide, however, CFTC's institutional knowledge would be lost if key personnel left the agency.

Further, CFTC does not routinely gather and use data on SRO sales practice audits or require SROs to submit summaries of member firm noncompliance disclosed during audits. As a result, the agency does not monitor, and thus is not aware of, SRO compliance with audit requirements or member firm compliance with sales practice standards disclosed during audits between scheduled RERS. For example, in July 1986, CFTC auditors visited CBT to do an RER and found that the exchange had completed only 29 of the 399 branch office audits expected for the year. Because CBT had completed so few branch office audits at the time of CFTC's visit, agency auditors could not complete planned audit work, and a follow-up RER was scheduled for early 1987. In September 1986, CBT submitted a revised audit schedule to CFTC, which the agency accepted, calling for fewer audits in 1986 and revised audit selection criteria.

Receipt and analysis of sales practice audit completion statistics and summaries of audit deficiencies could disclose developing problems or trends that would assist in effectively planning RERS. Regular review and analysis of SRO reports could also free CFTC's sales practice staff to devote more time during RERS to issues that require on-site analysis. Our review of RER reports disclosed considerable analysis of issues such as SRO audit staffing, scheduling, and results—analysis that could have been done between RERS based on SRO reports submitted to CFTC.<sup>8</sup> CFTC's Chicago office already receives SRO audit schedules and completion data that include sales practice audit information. However, these data are only used to monitor SRO compliance with financial audit requirements.

According to CFTC officials, although they do not continuously monitor SRO compliance, they take other actions to plan for RERS. Specifically, these officials told us that SROs now inform CFTC if they cannot meet their audit schedules and notify CFTC of all disciplinary actions taken, as required by CFTC rule 9.11(c). Further, CFTC officials said that CFTC staff also review all CFTC enforcement complaints and orders of investigation and meet regularly with SRO representatives to discuss audit and compliance matters.

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## **RER Reports Could Be Better Documented**

Generally accepted government auditing standards require audit documentation to include sufficient competent and relevant evidence to support auditor judgments and conclusions. Similarly, CFTC requires SROs to completely document audit work and to gather sufficient evidence to

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<sup>8</sup>See chapter 3 for further details on the absence of regular CFTC oversight of SRO and member firm compliance.

support audit conclusions. Although the CFTC RER reports we reviewed noted weaknesses and contained recommendations for program improvements, report documentation or analysis frequently did not support report statements or conclusions. In addition, CFTC report statements and conclusions were often contradicted by the available evidence. As a result, CFTC report statements may not support report recommendations, and recommendations may not always address SRO program deficiencies.

We found 49 report statements or conclusions from CFTC's most recently completed sales practice RERS of CBT, CME, NFA, and COMEX that agency workpapers did not support. Although we were able to verify that many conclusions were correct, we found that CFTC workpapers contained little or no evidence or analysis supporting these statements or conclusions. For example, CFTC concluded in an RER report that CBT audits covered all required areas, yet CFTC's workpapers did not contain sufficient evidence to support this conclusion. CFTC reports that it reviewed 59 audit files, but the workpapers contained no analysis to show what each file review disclosed. In a 1989 RER report, CFTC concluded that NFA's investigatory and disciplinary programs generally met regulatory requirements, yet the report and workpapers contained no analysis of what those requirements were or how NFA had complied with them. We identified other report statements or conclusions that may have been correct but that CFTC's workpapers did not support.

In addition, we found 21 report statements and conclusions that available evidence contradicted—evidence that either we obtained or that was available in CFTC's workpapers. For example, CFTC reported that NFA had met its 1988 requirement that each FCM be audited, yet our analysis (see ch. 3) showed that NFA did not meet its audit requirement for these firms in either 1987 or 1988. In the same report, CFTC reported that NFA had completed 213 audits of introducing brokers and that NFA audited these firms every 2 years, when, according to NFA officials, it had audited only 105 and has no regular audit schedule for these firms. In the COMEX RER, CFTC reported that six exchange member firms that the New York Stock Exchange (NYSE) audited under contract with COMEX would also be audited by CBT. CFTC concluded that this duplication was valuable because it meant that all firms were being audited by a futures SRO using approved audit procedures. In fact, two of these firms were not CBT members and thus were not subject to audit by that exchange.

CFTC officials agreed that their reports could be better documented and, to accomplish this, plan to combine financial and sales practice audit

oversight programs. They said their financial reviews have more stringent documentation requirements that will be applied to the sales practice audit segment.

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## CFTC Recommendations Are Not Always Implemented or Resolved

CFTC requires SROs to respond to agency recommendations made as a result of RERs but does not require SROs to indicate when recommendations will be adopted. A CFTC official told us that agency staff discuss RER findings with SRO representatives, and typically the SRO agrees before report issuance to correct any problems identified. In addition, CFTC has done 10 follow-up reviews to confirm that corrective actions have been taken. We found examples, however, in which SROs had not implemented CFTC recommendations that were repeated in one or more RER reports. CFTC has the legal and regulatory authority to require that SROs adopt its recommendations when disagreements are not resolved.

For example, CFTC recommended that CME improve audit and investigative procedures for disclosing high-pressure sales tactics. Similar recommendations were made in three separate RER reports issued to CME in 1985, 1987, and 1989. CFTC had reported in the 1985 report that CME's audits did not disclose problems at a firm that CFTC suspected of fraudulent high-pressure sales tactics. CFTC reported that the firm charged unusually high commissions and had been the subject of numerous customer complaints. CME, however, did not investigate this allegation or interview customers of the firm until 3 years later. On the basis of customer interviews, CME concluded that no basis existed for further inquiry. CME did not agree to improve sales practice audits and investigations until after the 1989 RER report and after CFTC's Division of Enforcement charged the same firm with fraud. Effective September 19, 1989, CME fined the firm \$100,000 for violation of exchange rules. At CME's request, the firm later withdrew as an exchange member.

Finally, in 1986, CFTC recommended that NFA develop a compliance program for enforcing the newly implemented NFA rule 2-30, referred to as the "know your customer" rule. This rule requires firms to disclose risk on the basis of an assessment of each customer's financial circumstances. CFTC concluded that NFA must develop compliance criteria to be incorporated into NFA's audit program and that the importance of the rule required a prompt review of its implementation. According to generally accepted government auditing standards, criteria are standards against which the adequacy of performance can be assessed. CFTC, however, did not review NFA again until 1989 when it reported that NFA audit guidelines still did not contain criteria for assessing firm procedures for

using customer information to determine what further disclosures of risk were necessary under the rule. CFTC again recommended that NFA provide compliance criteria for its auditors. NFA has not provided these criteria, however, because it opposes the use of a universal standard to determine compliance. NFA officials told us that the association believes it was responsive to CFTC's 1986 recommendation and that, in response to CFTC's 1989 report, it has agreed to provide its audit staff with additional guidance on compliance with the rule. CFTC officials told us, however, that a policy difference still exists on how to interpret compliance with the rule.

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## Conclusions

Sales practice RERS—the only routine examination-based program CFTC currently uses to oversee SRO sales practice programs—need to be improved to ensure that SRO enforcement and audits of sales practice requirements are more effectively reviewed. Standardized guidelines for conducting RERS could improve the usefulness of RERS by providing for continuity and consistency in doing sales practice RERS and by ensuring better coverage of compliance with sales practice requirements. Guidelines could include audit steps covering each sales practice area and requirements for minimum analysis and documentation. Preparing and using standardized guidelines would not require analysis of all compliance areas—such as areas found to be in past compliance—during each review. CFTC should, however, document which compliance areas are not covered and why. Also, standardized guidelines would not preclude using analytical techniques tailored to each situation nor prevent CFTC reviews from targeting problem areas. Improved RERS could provide CFTC better assurance that SROs meet their oversight responsibilities and, therefore, that investors receive needed protection. Also, CFTC needs to ensure that disagreements with SROs regarding repeated RER recommendations are resolved or that SROs implement appropriate recommendations.

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## Recommendations

We recommend that the Chairman, CFTC,

- prepare standardized sales practice RER guidelines that cover all sales practice requirements and include audit steps and documentation requirements and
- either resolve disagreements over RER recommendations or use its legal and regulatory authority to require SROs to adopt recommendations for program improvements made as a result of RERS.

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## Agency Comments and Our Evaluation

In its comments, CFTC noted that it plans to improve its sales practice oversight program in general and in response to our report. It also noted that it is committed to making additional changes whenever it is convinced that such changes would further improve the program. However, in this regard, CFTC expressed reservations about some of our observations and recommendations on the basis of its belief that our report reflected a misunderstanding of the integrated nature of its multiprogram regulatory scheme. It pointed out that SRO sales practice audits are only one component of CFTC's multiprogram approach and said that no one program in and of itself would be sufficient to deter sales practice abuses.

This response indicates to us that CFTC misunderstood the purpose of our review and consequently took our findings and recommendations out of the context we intended. We recognize CFTC's multiprogram approach, and it was never our intent to review it in its entirety. Rather, our purpose was to do a compliance review of one component of the multiprogram approach—the component directly related to sales practice oversight. Our intent was to determine how well that component was complying with CFTC's established procedures. Our logic in doing so was that if one of the components was not functioning as intended, the synergistic benefits from the multiprogram approach would not accrue as CFTC expected.

Thus, we did not suggest that CFTC change its total regulatory approach. Rather, our recommendations are designed to bring one part of that approach—the sales practice oversight program—into further compliance with the procedures CFTC has established for that program's operation.

CFTC's misunderstanding of our purpose is illustrated by its reaction to our recommendation that it develop standardized sales practice guidelines. CFTC's interpretation was that we were recommending a checklist approach to CFTC's overall oversight of the industry. It objected that using such a checklist would constitute a more comprehensive overall approach that would preclude targeting problem areas while requiring significant additional resources.

Our recommendation did not extend to CFTC's overall regulatory approach. Rather, it was our intent that CFTC prepare and use standardized review guidelines to ensure that sufficient audit work is done to cover SRO compliance with all sales practice requirements and to support

and adequately document its conclusions. Neither was our recommendation intended to preclude CFTC reviews from targeting SRO programs in need of special attention. We added language to the report to provide additional clarity on this subject (see p. 20). Finally, we do not agree with CFTC's assertion that using standardized guidelines for its reviews would necessarily require additional resources. We expected that the guidelines would be used by the existing workforce. Nevertheless, we commend CFTC's decision to increase the staffing of its sales practice audit and financial oversight programs by two positions for fiscal year 1991.

Similarly, CFTC misinterpreted our intent in recommending that CFTC either resolve disagreements or use its regulatory authority to require SROs to adopt program improvements recommended as a result of RERS. CFTC noted that using broad enforcement remedies may not be appropriate, because staff recommendations often highlight areas where exchanges may wish to undertake program improvements rather than always identifying areas of deficiency. CFTC also inferred that use of its authority would not always be appropriate, because SROs have paid serious attention to its recommendations.

It was not our intent to suggest that CFTC use its enforcement authority to secure compliance with each of its recommendations. Our concern centered on those RER recommendations that were repeated in one or more RER reports. For example, one SRO did not agree to improve audit and investigative procedures until CFTC recommended that it do so in three RER reports. Thus, repeated recommendations related to correcting significant deficiencies were the focus of our recommendation for CFTC to better resolve disagreements over RER recommendations. We added language in our final report to better clarify our intent (see p. 20).



# Sales Practice Audit Oversight, Enforcement, and Coverage Need Strengthening

CFTC relies primarily on the SROs to ensure that member firms comply with sales practice rules and regulations. The SROs' principal means of overseeing member firm compliance is through annual audits of their sales practice programs. In addition to improving its RER coverage of these audits, as discussed in chapter 2, CFTC needs to take additional actions to strengthen its oversight. These actions include (1) regularly collecting data on SRO audit compliance and results, (2) enforcing existing audit requirements and revising others to close gaps in coverage, and (3) requiring improvements to SRO audit guidelines. Strengthening these areas could provide more complete and consistent coverage of industry sales practice compliance and help ensure that the customers of all firms are adequately protected from sales practice fraud and abuse.

## SRO Sales Practice Audit Responsibility

Provisions of the Commodity Exchange Act and CFTC regulations provide for overlapping responsibility among SROs for sales practice audits of industry firms. NFA is responsible under the act and regulations for auditing all NFA member firms, including those firms with exchange memberships. NFA audits are required to include procedures to test compliance with rules related to the sale of both commodity futures and options—referred to as general sales practices. In contrast, the exchanges are only responsible under CFTC regulations for audits related to the sale of options.

Actual audit responsibility, however, is further divided among SROs, because futures firms are frequently members of more than one SRO. To avoid duplicate audits, SROs assign audit responsibility for each firm to a single designated SRO. NFA and the exchanges also have contracts with other SROs, including NYSE, to do sales practice audits. CFTC regulations allow SROs to delegate audit responsibility to another SRO.

Table 3.1 shows FCM audit responsibility, by futures SRO, as of December 31, 1989.

**Chapter 3  
Sales Practice Audit Oversight, Enforcement,  
and Coverage Need Strengthening**

**Table 3.1: SRO Audit Responsibility**

SRO	Number of FCMs assigned for audit	
	General sales practice audits	Options-only audits
As of December 31, 1989		
CBT	95	
CME	33	
Coffee, Sugar and Cocoa Exchange		14
COMEX		19
Kansas City Board of Trade	9	
New York Cotton Exchange		5
New York Futures Exchange		50
New York Mercantile Exchange		15
NFA	140	
<b>Total</b>	<b>277</b>	<b>103</b>

Note: Only CBT, CME, and the Kansas City Board of Trade are under contract with NFA to do general sales practice audits of their designated member firms.

Source: NFA.

CFTC requires SROs to complete assigned sales practice audits of FCMs every year, alternating between full- and limited-scope audits.<sup>1</sup> CFTC also requires each SRO to complete a financial compliance audit of each member FCM, and these audits are usually done at the same time as the full-scope sales practice audit. For branch offices,<sup>2</sup> CFTC requires SROs to audit either (1) 10 percent of all branch offices of member FCMs or (2) all branch offices with 10 percent or more of a firm's business volume—referred to as the 10/10 rule. CFTC also allows reasonable alternatives to these requirements, including combinations of the two audit selection methods.

**CFTC Does Not Regularly Collect Data on SRO Audits**

CFTC does not request or maintain the information necessary to monitor compliance with audit requirements between RERS, assess the adequacy of audit coverage these requirements provide, or identify industry trends of violations that sales practice audits disclose. CFTC does not maintain this information despite the importance of SRO member firm audits. Sales practice audits are an essential component of an SRO oversight program and are used to test member firm programs for compliance with SRO rules and to deter and detect customer abuse. As

<sup>1</sup> A full-scope audit is a complete review of member firm compliance as defined in CFTC guidance. In contrast, a limited-scope audit tests compliance only in areas the SRO selected.

<sup>2</sup> A branch office is a remote sales operation of an FCM.

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discussed in chapter 2, regular oversight could also improve RER planning.

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## No Regular Compliance Monitoring

Despite requirements for regular sales practice audits, CFTC does not request or receive from SROs sales practice audit plans or records of audits that were completed, as discussed in chapter 2. As a result, CFTC does not monitor SRO compliance with sales practice audit requirements during the time between RERS, which has ranged from about 1 year to over 5 years. The only data CFTC was able to provide on SRO compliance with its own audit requirements were the data contained in RER reports. Because of the way the information was reported and the lack of details, however, we were unable to determine SRO compliance from the data in these reports. As reported in chapter 2, we also sometimes found these data to be inaccurate.

Our review of CBT and NFA audit completion data for calendar years 1987 and 1988 disclosed noncompliance with CFTC audit coverage and frequency requirements that CFTC had not reported. Our analysis showed that CME and CBT complied with CFTC's requirement to audit FCMS, while CME and NFA complied with CFTC's 10/10 rule for branch office audits. However, CBT did not audit all of the branch offices required, and NFA did not audit all of the required FCMS. CBT applies a combination of CFTC's 10/10 rule to its member firm's branch offices. CBT audits the branch offices of its FCM-only member firms using the 10-percent universe requirement. Applying this criterion, CBT audited more than the required number of branch offices of its FCM-only members. CBT audits the branch offices of its generally larger FCM members that are also securities broker-dealers using the 10-percent volume requirement. However, CBT did not audit all of the branch offices required for these member firms. Our analysis showed that CBT audited 21 of the 27 branch offices of these firms that we could confirm required audits in calendar year 1988.<sup>3</sup> We also found that NFA did full-scope audits of only 53 of the 72 FCMS that we could confirm required such audits during calendar years 1987 and 1988. Although CBT's noncompliance was apparently an oversight, NFA's noncompliance was caused by its policy not to regularly

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<sup>3</sup>However, CBT audited 40 additional branch offices of these firms that CFTC did not require. CBT audits the branch offices of FCM-only firms using the 10-percent universe requirement and audits the branch offices of FCMS that are also securities broker-dealers using the 10-percent volume requirement. In 1989, according to CBT officials, the exchange modified its audit selection under the 10-percent volume requirement with CFTC approval. CBT now substitutes another branch office for audit if a 10-percent volume branch office did not have material exceptions in the prior-year audit.

audit all fully disclosed FCMs.<sup>4</sup> As discussed in the following section, NFA's policy is inconsistent with CFTC's sales practice audit requirements. Without complete and regular monitoring, CFTC cannot ensure that SROs comply with sales practice requirements or that member firms receive regular sales practice audits.

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### No Assessment of Audit Requirements or Tracking of Industry Trends

CFTC was unable to provide us from its records the information needed to determine past SRO compliance with its branch office audit requirements or to assess the adequacy of audit coverage. We had to gather this information from the SROs. CFTC does not maintain any records of branch offices requiring audits or of the audits these offices received, other than those obtained during an RER. Without this information, CFTC cannot assess the adequacy of branch office audit coverage or evaluate the need to adjust its requirements to improve audit coverage. For example, we found that 58 firms in 1988 had none of their branch offices audited. The adequacy of coverage provided by branch office audit requirements was also not addressed in any RER report we reviewed.

In addition, CFTC does not compile, or require SROs to submit, summaries of member firm audit deficiencies disclosed during sales practice audits. CFTC officials told us they did not believe the summarization and analysis of audit deficiencies would yield meaningful results. However, these deficiencies could indicate patterns of violations of SRO rules or CFTC regulations. In addition, CFTC does not obtain reports on member firm resolution of audit deficiencies. As a result, CFTC does not have the information needed to assess SRO audit quality, track the resolution of SRO audit deficiencies, or identify trends of sales practice violations industry audits disclose, other than those resulting in disciplinary actions. We noted only limited analysis of SRO member firm audit deficiencies in RER reports.

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### CFTC Requirements Are Not Enforced and Allow Gaps in Coverage

CFTC's Sales Practice Audit Interpretation is the only formal guidance the agency provides to SROs on sales practice audit program requirements, other than the guidance contained in RER reports. As discussed in the previous section, this guidance includes audit frequency and coverage requirements for SRO sales practice audits of member firms and branch offices. However, CFTC's requirements for annual audits of each

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<sup>4</sup>A fully disclosed FCM must forward all customer funds that it receives to another firm that maintains a separate account for each of the fully disclosed FCM's customers.

FCM, covering both futures and options sales practice compliance, were not always followed or enforced, allowing potential gaps in audit coverage. In addition, CFTC branch office audit requirements are incomplete because they do not provide for audit coverage of all firms.

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## CFTC Audit Requirements Are Not Enforced

CFTC requires that each FCM receive an annual sales practice audit, alternating between full and limited scope, and that these audits include tests for compliance with both futures and options sales practice rules. Our review at NFA, however, showed that NFA did not provide full-scope audits for all fully disclosed FCMs or provide audit coverage of futures sales practices for many other firms.

NFA does not audit fully disclosed FCMs on a regular schedule as is required by CFTC's annual audit requirement. As previously discussed, NFA did full-scope audits of only 53 of the 72 FCMs that required such audits during calendar years 1987 and 1988.<sup>5</sup>

According to NFA, all of the firms not receiving a full-scope audit were fully disclosed. As of August 1989, approximately 80 FCMs, or over 22 percent of all registered FCMs, were fully disclosed. NFA does not regularly audit fully disclosed FCMs for sales practice compliance as CFTC requires, because these firms do not hold customer funds. Instead, NFA uses a priority system based on factors such as the number of customer complaints to select these firms for audit.

NFA officials said their policy not to audit fully disclosed FCMs on a regular schedule is based on CFTC's policy that an annual financial audit is not required if a firm does not hold customer funds. CFTC's Sales Practice Audit Interpretation states, however, that in contrast to a financial compliance program, the need for a sales practice audit should be based on the extent of a firm's retail customer business and not on whether the firm holds customer funds. According to NFA officials, at least 6 of the 19 FCMs that were not subject to a full-scope audit had an active retail customer business.

CFTC had reported in its 1989 RER of NFA that the association complied with the FCM audit requirement. CFTC officials told us in May 1990 that they were not aware of NFA's policy not to conduct regular audits of

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<sup>5</sup>NFA did at least one limited-scope audit at each of the remaining firms during this period. NFA's limited-scope audit includes many sales practice-related audit steps and, according to NFA officials, has been expanded in scope, but it does not cover all areas required by CFTC's Sales Practice Audit Interpretation.

fully disclosed FCMS. Although they agreed that the sales practice interpretation required SRO audits to focus on firms with retail business, they added that the language in the sales practice interpretation was ambiguous and could have been misinterpreted.

In addition, CFTC had not enforced the requirement that all firms in the industry receive a general sales practice audit, which, as discussed above, covers both commodity futures and options sales practices. NFA has contracted with CBT, CME, and the Kansas City Board of Trade for these exchanges to conduct futures sales practice audits of their designated member firms in addition to the options-only audits that all SROs are required to provide. The remaining five exchanges with audit responsibility<sup>6</sup> do not have contracts with NFA. These exchanges are responsible for auditing 103 FCMS, representing 28 percent of all registered FCMS, but only for the options component of a general sales practice audit. As a result, NFA is responsible for auditing these 103 firms for the futures component, but, according to NFA, it audits few of these firms. NFA officials said the association does not audit the remainder of these firms because few of them have retail customer business.

CFTC reported in its 1989 RER report that NFA need only audit these 103 firms when the circumstances warrant, because the firms have mostly institutional and not retail customers. In addition, according to CFTC officials, these firms generate very few customer complaints or reparations cases. However, although individual RERs have recommended surveys of customer business, the agency has not required the SROs to confirm the extent of retail customer business to determine whether an audit is needed at each firm. Such a determination is not made during regularly scheduled financial and options sales practice audits. According to NFA officials, little additional time would be required for the exchanges to cover futures sales practice compliance during their audits of those firms that had retail customer business.

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### **CFTC Branch Office Requirements Are Incomplete**

According to the CFTC interpretation, routine sales practice audits of FCM branch offices are an essential component of a sales practice program. FCM branch offices are to be audited to verify the adequacy of home office supervision of their remote sales operations and to ensure compliance with sales practice standards. However, CFTC's audit requirement does not specify that at least some branch offices of all SRO member

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<sup>6</sup>Currently nine SROs—eight futures exchanges and NFA—are responsible for auditing all industry FCMS. Several small SROs do not have audit responsibility.

firms be audited or that different branch offices be audited each year. As a result, many firms have no branch offices audited or have the same branch offices audited each year. The latter precludes obtaining a more complete picture of the whole firm's performance. In addition, CFTC has provided insufficient guidance on the business volume component of the requirement, which could result in inconsistent compliance.

CFTC's 10/10 rule<sup>7</sup> does not specify that at least one branch of every firm be audited. As a result, some firms may have no branch offices audited, and compliance with sales practice rules at branch offices will not be verified. At CBT, CME, and NFA, 58 firms out of a total of 109 FCMs with branch offices had none of the branches audited in 1988. These SROs chose not to audit any branch offices of 41 of these firms, as allowed under CFTC's 10-percent universe requirement, and did not audit any branch offices of another 17 firms because none met the 10-percent volume criterion. The 58 firms had a total of 270 branch offices, according to data the three SROs supplied.

CFTC's rule also allows actual branch office audit coverage to be overstated to achieve compliance. CFTC allows audits of FCM home office sales operations to count toward meeting the branch office audit requirement, although these audits do not test remote supervision or compliance and are already done as part of a full-scope audit. For example, by excluding home office audits, NFA would not have met its 1988 branch office audit requirement. Home office sales operations should receive a sales practice audit each time an SRO does a full-scope audit at an FCM.

Application of CFTC's branch office audit requirement can also result in the same branch offices being audited each year. The volume criterion requires that a branch office be audited if its volume exceeds 10 percent of total firm volume. This places an appropriate audit emphasis on those branch offices that do the most business. According to SRO officials, however, unless changes in business volume occur, this requirement results in the same offices being audited each year, regardless of past compliance, making it obvious to firm management which branch offices will be audited. Auditing different branch offices would test compliance of the entire firm. In addition, the element of surprise that would result would prevent firms from advance preparation that could be designed to hide the extent of any noncompliance with sales practice requirements.

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<sup>7</sup>As described earlier in this chapter, the CFTC audit requirement, referred to as the 10/10 rule, allows each SRO to choose to audit either (1) 10 percent of all member firm branch offices or (2) only those branch offices that do 10 percent or more of a member firm's business. CFTC also allows combinations of these two rules.

Finally, compliance with CFTC's requirement is inconsistent, because CFTC has not defined how business volume should be computed and reported. In a 1988 RER report on CBT, CFTC recommended that CBT verify the accuracy of business volume firms reported because, according to a CFTC official, the amounts reported might not be reliable. However, the accurate reporting of business volume as identified by CFTC remains a problem. We found that member firms include inappropriate amounts when computing total business volume and do not consistently report totals.

For example, the form CBT and CME member firms use to report business volume allows the firms to add home office proprietary and professional trader accounts to total firm volume. According to CFTC officials, these accounts are not subject to sales practice standards and do not reflect branch office volume. Including these accounts increases total firm volume and may reduce the number of branch offices meeting the 10-percent threshold and therefore requiring an audit. In addition, the firms we reviewed used different methods to compute the number of branch offices subject to audit. According to CFTC officials, the agency plans to address this problem in an upcoming RER report.

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## **SRO Audit Guidelines Are Incomplete**

Sales practice audits of industry firms are intended to determine whether each firm is complying with CFTC regulations and SRO rules, and whether customers are being protected from abuse. Complete and consistent compliance with sales practice rules requires thorough and standardized testing procedures. We found, however, that compliance may not be consistently tested, because the audit guidelines that many SROs use are incomplete.

The Joint Audit Committee<sup>8</sup> has approved sales practice audit guidelines for industrywide use. These guidelines—a check-list of audit procedures the SROs use to audit designated FCMS and their branch offices—have been approved by CFTC for use by all SROs.<sup>9</sup> We reviewed it to assess coverage of the applicable sales practice requirements we had identified. We found that the guidelines do not provide complete coverage of several of the sales practice areas that CFTC's sales practice interpretation requires (see app. I). These areas included the review of (1) new

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<sup>8</sup>The Joint Audit Committee is composed of SRO representatives and was organized to coordinate industry audit activities.

<sup>9</sup>NFA uses its own set of expanded audit guidelines to audit its assigned member firms, while CBT uses a supplement to the joint audit guidelines.



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employee training, (2) incoming customer correspondence, (3) aspects of sales operations, and (4) compliance with the requirement to gather information on each customer's financial condition required by NFA's "know your customer" rule. In addition, numerous audit steps from the guidelines are not required to be completed for options-only audits. As a result, several additional sales practice requirements may not be reviewed or reviewed as thoroughly during options-only audits. These include review of (1) sales communications, (2) disclosure requirements, (3) corporate accounts, and (4) supervisory procedures. As a result of these omissions, coverage of FCM compliance with sales practice requirements may be incomplete.

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## Conclusions

CFTC needs to improve its oversight of SRO sales practice audits to more effectively coordinate and enforce futures industry self-regulation of sales practice standards. CFTC needs to improve monitoring of SRO compliance with audit frequency requirements, assess the adequacy of these requirements, analyze trends of sales practice violations disclosed by industry audits, and review SRO member firms' resolution of audit deficiencies. Regular monitoring of these and other SRO activities would provide for more continual oversight, allow developing problems to be identified and corrected more quickly, and provide a basis for planning more in-depth RERS.

CFTC also needs to enforce existing requirements for general sales practice audits of all industry firms or approve alternative audit requirements. CFTC also needs to assess the branch office audit coverage achieved under existing requirements and make adjustments as necessary to improve audit coverage of industry firms. Finally, CFTC needs to ensure that the joint audit guidelines cover all sales practice requirements. These improvements could provide more complete and consistent audit coverage of sales practice compliance in the futures industry and help ensure that futures industry customers are adequately protected from abusive sales practices.

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## Recommendations

We recommend that the Chairman, CFTC,

- direct SROs to provide CFTC with the information needed to (1) monitor and assess SRO compliance with sales practice audit requirements, (2) analyze trends of sales practice violations disclosed by industry audits, and (3) review the timely resolution of these violations;

- enforce requirements for sales practice audit coverage of all industry FCMS, including coverage of both futures and options sales practices;
- improve branch office audit selection criteria to ensure that at least some branch offices of all firms requiring coverage are audited; and
- ensure that SROs' sales practice audit guidelines provide coverage of compliance with all sales practice audit requirements.

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## **Agency Comments and Our Evaluation**

CFTC commented on only two recommendations. It agreed to refine its branch office audit selection requirements but said that regular monitoring of SRO compliance between RERS is a fundamentally different approach to oversight than has historically guided its program and that this approach could require substantial additional resources. Regular monitoring is needed to ensure timely and continuous federal oversight of futures industry compliance with sales practice requirements and to improve planning for periodic on-site reviews, as explained in this chapter. Also, regular monitoring could result in better use of existing resources. We have expanded on this point in the report (see pp. 17 and 31). We do not know the amount of resources the recommended monitoring would require, but CFTC's decision to increase staffing and integrate its sales practice and financial compliance oversight programs may provide the additional resources needed, if any.

# A Requirement for Fair and Reasonable Futures Commissions Is Needed

Two recent CFTC sales practice fraud cases, one the largest in CFTC history, allege misrepresentation of profit potential and customer losses of over \$460 million. CFTC also alleges that high commissions, totaling about \$323 million, materially affected the likelihood of profits and accounted for a significant portion of these losses. Unlike the securities industry, no specific rules or regulations addressing excessive sales commissions exist in the futures industry. A requirement for fair and reasonable futures commissions would provide a specific means to limit the ways in which disreputable firms could legally disadvantage customers. Currently, the industry relies on firms to disclose their charges and on potential customers to decide whether those charges are justified. Determinations of fraud must be made in court under general fraud statutes. Recent allegations of sales practice abuse, however, have raised doubts about the adequacy of this approach.

## Recent Cases of Alleged Abuse Involve Excessive Commissions

On September 11, 1989, CFTC charged two FCMS with fraud, alleging customer losses of over \$460 million since 1984. CFTC charged these firms with fraudulent high-pressure sales tactics in selling commodity options to the public. In addition, both firms allegedly charged customers commissions of 40 percent or more while over 80 percent of their customers lost money. According to the CFTC charges, one firm charged a 45-percent commission plus \$310 in transaction fees on each commodity option purchased and then sold. According to CFTC, the firms charged customers a total of about \$323 million in commissions.

CFTC's complaints allege fraudulent misrepresentation and omission of material facts to induce customers to purchase commodity options. Although CFTC's complaint states that high commissions were charged, the list of charges does not include excessive commissions. Neither CFTC nor the SROs have rules that prohibit or specify what constitutes excessive commission rates. To prove the charges of fraud, CFTC developed extensive details on each firm's alleged fraudulent high-pressure sales tactics.

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## The Securities Industry Requires Fair and Reasonable Commissions

The National Association of Securities Dealers (NASD)<sup>1</sup> and Municipal Securities Rulemaking Board (MSRB)<sup>2</sup> both prohibit mark-ups and commissions<sup>3</sup> that are not fair and reasonable. The NASD rule states that a member shall not charge a customer more than a fair commission considering the conditions of the market, the expense of executing an order, and the value of any services rendered, while taking into account the member's experience and knowledge. The MSRB rule is almost identical to the NASD rule. Merely disclosing the amount of a mark-up or commission does not satisfy either organization's rules.

NASD and MSRB, however, have implemented their rules differently. NASD has established pricing guidelines providing that a mark-up or commission greater than 5 percent above the prevailing market price may be excessive. This policy is only a guideline, and commission charges above 5 percent are not necessarily rule violations. NASD recognizes that the facts of each case will determine what is excessive. The Securities and Exchange Commission has also consistently ruled that any mark-up or commission of more than 10 percent above the prevailing market price for equity securities is fraudulent if not disclosed. Even if disclosed, however, a commission in excess of the Securities and Exchange Commission standard could still violate NASD's rule. MSRB also considered establishing pricing guidelines but did not do so because of industry opposition. Rather than set pricing guidelines, MSRB chose to issue additional guidance to its members on compliance with its rule and to closely monitor compliance.

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## The Futures Industry Does Not Regulate Commissions

Futures industry policy, as reflected in NFA rules, requires full disclosure of the commissions and fees that NFA members receive but does not regulate the amount of such compensation. NFA rules require member firms to disclose to individual public customers all fees and charges before a customer begins trading, including a written explanation of any charges not determined on a per-trade basis. The policy relies on potential customers to decide whether these charges are justified. NFA's philosophy is

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<sup>1</sup>NASD is the securities industry SRO for the over-the-counter stock market. Over-the-counter stocks are those not bought or sold on an exchange.

<sup>2</sup>MSRB is the SRO for the municipal securities industry.

<sup>3</sup>Mark-ups and commissions are broker fees for completing a securities transaction for a customer. A mark-up is charged if the broker acts as a dealer or principal in a transaction. A commission is charged when the broker acts as the customer's agent in purchasing or selling a security. According to NFA officials, futures industry brokers generally act as agents for their customers and not as dealers or principals in a transaction. As a result, they charge commissions.

that a well-informed customer is in the best position to determine how much a firm's services are worth. Charging excessive commissions does not violate existing rules as long as the costs are fully disclosed to the customer.

NFA officials told us that regulating commissions was unnecessary because other NFA rules can be used to discipline members for excessive charges to customers. These rules prohibit cheating or defrauding customers and other practices intended to deceive or mislead customers. These rules do not prohibit excessive commissions but rather depend on disclosure and the ability to prove deception. These officials also said that a reasonableness standard would be too difficult to enforce and a pricing guideline is undesirable because it might become the rate charged. NFA officials said that they would support, as an alternative, issuing further guidance to members on compliance with existing disclosure rules. CBT officials told us, however, that they would not object to a rule regulating commissions because enforcing it might be simpler than proving fraud. CME officials said that they were opposed to a rule because it would be too difficult and expensive to enforce. According to CFTC officials, the agency favors disclosure over regulation of commissions. In a November 1990 opinion, CFTC, on a procedural point, reversed a hearing officer's reparations decision that commissions charged by a firm were both not properly disclosed and fraudulent. In a concurring opinion, the CFTC Chairman rejected arguments for regulating the level of commissions and defended CFTC's policy of relying on full disclosure to protect customers.

Despite evidence that excessive commissions are a problem, as illustrated by the two recent cases of alleged fraud discussed earlier, neither CFTC nor NFA collects or maintains data on commission charges in the industry. Without these data, an SRO does not have the information needed to determine standard industry practices or to identify the extent to which excessive commissions may be charged. This information is also needed to address CFTC recommendations in an August 30, 1989, letter to the Joint Compliance Committee<sup>4</sup> to identify and monitor firms with unusual commission structures. In addition, such information, if made available, could help customers make informed decisions under existing rules on the reasonableness of commissions charged.

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<sup>4</sup>A committee of exchange and NFA representatives that coordinates industry compliance activities.

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## Conclusions

Recent examples of excessive commission charges demonstrate the limitations of NFA's disclosure policy for protecting customers. First, the disclosure rule depends on the firm to accurately explain and disclose its commission charges. Second, the rule depends on the customer to know whether the amounts charged are fair and reasonable.

A rule requiring commissions to be fair and reasonable would provide the industry with an additional enforcement tool and would not preclude continued enforcement of existing rules. The rule would serve as a deterrent to abuse, and enforcement action could be brought against a firm by an SRO, rather than requiring CFTC to prove fraud. Such a rule would not prevent fraud, rather it would make excessive commissions an SRO rule violation. Regarding concerns about difficult implementation, reasonableness rules have existed and been enforced in the securities industry for many years. Further, a rule requiring fair and reasonable commissions need not require that specific pricing guidelines be established—MSRB has implemented its rule without them. With or without a rule, collecting data on commission charges could help the industry identify and investigate problem firms and help industry customers make informed decisions about the fairness of commissions.

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## Recommendations

We recommend that the Chairman, CFTC, require NFA to

- collect and report to the agency data on commission charges in the industry and
- adopt a rule requiring fair and reasonable commissions.

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## Agency Comments and Our Evaluation

CFTC was not convinced of the policy merits of a rule regulating commission rates. CFTC noted that such a rule could have unintended anticompetitive effects and might be circumvented by hidden charges to customers. As stated in the report, such rules already exist and are enforced in the securities industry. In addition, all charges to a customer, whether a firm attempts to hide them or not, should be included under any reasonable definition of what constitutes excessive fees, and any attempt to hide charges to the customer would then violate disclosure rules.



# CFTC Sales Practice Audit Requirements

We identified and compiled this list of requirements from CFTC formal guidance to SROs contained in its Sales Practice Audit Interpretation and from CFTC regulations (17 C.F.R. 33). SROs must comply with these CFTC and regulatory requirements in carrying out a program of sales practice audits of its member firms. The requirements obtained from CFTC guidance apply to both commodity futures and options sales practice audits, while those obtained from the regulations apply almost exclusively to options sales practice audits.

The source and description of each requirement follows:

1. Adequacy of audits. CFTC regulations (17 C.F.R. 33.4(c)) specify that each exchange that trades options must conduct sales practice audits of member FCMS that are adequate in scope to test for compliance with exchange rules.
2. Adequacy of staffing. CFTC guidance requires the SROs to have an adequate audit staff with appropriate training, experience, and supervision to carry out program responsibilities.
3. Independence. CFTC guidance requires SRO officers and auditors to maintain an independent mental attitude to avoid conflicts or the appearance of conflicts.
4. Documentation. CFTC guidance requires audit work to be thorough and clearly and completely documented.
5. Disciplinary action. CFTC guidance requires SROs to act expeditiously when evidence exists of possible wrongdoing. If such evidence exists, SROs must take prompt and appropriate remedial and punitive action; notify CFTC of all questionable sales, marketing, or account management practices identified during audits, especially when these practices appear pervasive at a firm or approved or acquiesced in by firm management; and closely monitor firms when audits reveal significant incidents of sales practice abuse.
6. Audit planning. CFTC guidance requires the SROs to concentrate audit resources on firms handling significant retail customer business. The level of audit scrutiny should increase when a firm deals with customers inexperienced in futures trading or with limited financial resources. Audits should examine related or affiliated firms as necessary. SROs should address each firm on a case-by-case basis, approach audits with a questioning attitude, and adjust audit scope to fit each firm.



7. FCM and branch office audit scheduling and completions. CFTC guidance requires sales practice audits of FCMs every year, alternating between full-scope and limited-scope audits. In addition, each SRO should annually visit at least 10 percent of the branch offices of its designated FCMs or all branch offices that do 10 percent or more of an FCM's business. SROs can follow a reasonable alternative schedule if necessary.

8. Order tickets. CFTC guidance requires a sales practice audit to include a review of the current day's order tickets to ensure that improper trade allocations and other abuses are not occurring.

9. Internal supervision. According to CFTC regulations (17 C.F.R. 33.4(c)), audits should include an evaluation of the adequacy of internal supervision. CFTC guidance also requires audits to review supervisory procedures to compare stated procedures with actual firm operations, including reviews of advertising supervision, sales personnel, new account acceptance, order entry, discretionary accounts, customer correspondence, and customer complaints.

10. Training new employees. CFTC guidance requires audits to include a review of training procedures for newly employed salespersons to determine whether employees are informed of regulatory requirements.

11. Registration. CFTC guidance requires that audits include testing to ensure that employees are properly registered. The Commodity Exchange Act requires employees to be registered before accepting orders from the public.

12. Incoming customer correspondence. CFTC guidance requires audits to include testing of an appropriate sample of correspondence to ensure that appropriate management personnel review all incoming correspondence and that customer complaints are identified and handled properly.

13. Customer complaints. According to CFTC regulations (17 C.F.R. 33.4(c)) and guidance, SRO audits of firms should review the handling and disposition of customer complaints to ensure resolution and correction of the causes of complaints. The regulations (17 C.F.R. 1.51(4)) also state that a contract market shall have a program to investigate the customer complaints it receives.

14. Sales communications. According to CFTC regulations (17 C.F.R. 33.4(c)), audits should include review for fraudulent or high-pressure

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sales communications. CFTC guidance requires audits to include an analysis of promotional material to determine that necessary disclosures are made and that rules for review of promotional material are followed.

15. Disclosure requirements. According to CFTC regulations (17 C.F.R. 33.4(c)), audits should review for compliance with disclosure requirements. CFTC guidance requires audits to include a review of new account forms, including risk disclosure statements, for the completeness of required information. SROs should ensure that the firm has obtained such information and documents within required timeframes. Audits should also include the review of accounts for compliance with NFA's "know your customer" rule to confirm that required information was obtained from customers and to determine whether required special disclosures were made.

16. Corporate accounts. CFTC guidance requires audits to include a check of corporate account documentation to ensure that corporate management has authorized the firm to engage in futures trading.

17. Employee accounts. CFTC guidance requires audits to include a review of employees' accounts to determine whether the potential for customer abuse exists.

18. Discretionary accounts. According to CFTC regulations (17 C.F.R. 33.4(c)), audits should review handling of discretionary accounts. CFTC guidance requires audits to include a review of discretionary accounts for potential abuses in initial solicitation, unauthorized trades, churning (excessive trading to generate commissions), and trade allocation between customer accounts or customer and employee accounts.

19. Account statements. CFTC guidance requires audits to include a review of customer accounts to include verification that confirmation statements, purchase and sales statements, and monthly statements are accurate and have been mailed to customers in a timely manner.

20. Sales operations. CFTC guidance requires that during branch office audits auditors should monitor salesperson conversations for questionable conduct and review the availability of customer support services claimed.

21. Sales of deep out-of-the-money options. According to CFTC regulations (17 C.F.R. 33.4(c)), audits should review, where applicable, FCM offer or sale of deep out-of-the-money options for possible abuse. These

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options have little market value and have been the subject of past sales practice abuses.

# Comments From the Commodity Futures Trading Commission

Note: GAO comments supplementing those in the report text appear at the end of this appendix.



## COMMODITY FUTURES TRADING COMMISSION

2033 K Street, N.W., Washington, D.C. 20581  
(202) 254-6970

December 6, 1990

Wendy L. Gramm  
Chairman

Mr. Richard L. Fogel  
Assistant Comptroller General  
General Government Division  
General Accounting Office  
Washington, D.C. 20548

Dear Mr. Fogel:

We appreciate the opportunity to comment on the GAO's draft report entitled FUTURES MARKETS: Strengthening Sales Practice Oversight ("Draft Report"). The Commission believes that many of the observations and recommendations made in the Draft Report reflect GAO's apparent disagreement with the policy judgments that have shaped the design and operation of this program. The premise of the Draft Report appears to be that the Commission's program should consist of rule enforcement reviews that evaluate the effectiveness of each SRO's sales practice audit program using only a checklist of staff-developed minimum standards for SRO sales practice audit programs, rather than using these standards as a departure point for an individually tailored evaluation. The Commission believes that this fundamental policy difference should be explained by GAO and that the CFTC's view of the purpose, scope and resource allocations appropriate to its program should be included in the Draft Report.

We are concerned that GAO has not evaluated the Commission's sales practice audit oversight program in light of the objectives the program was intended to meet. The Commission's program is intended to enhance retail customer protection by reviewing the effectiveness of SRO sales practice audit and compliance programs. The program seeks to assure that SROs target firms with retail business or histories of improper sales practices. The program is implemented by a limited number of experienced staff. With few exceptions, this staff has worked on the Commission's sales practice oversight program since its inception in 1983.

The scope of each Commission staff rule enforcement review is based on accumulated expertise and judgment and trends of sales practice violations disclosed by a number of sources, including customer complaints, enforcement investigations and actions, notices of exchange disciplinary proceedings and the results of prior reviews. These reviews identify specific sales practice issues of current importance to assure that SRO programs assign priority to such issues and to practices which may pose the greatest risk to customers, and firms at which most abuses

See pp. 21-22.

See comment 1.

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are likely to occur. For example, among other things, rule enforcement reviews have directed SRO attention to the need for specific SRO rules addressing additional disclosure for unsophisticated customers and disclosure of trading charges, the potential special supervisory demands of night trading, the desirability of special monitoring of firms which hire uncharged sales persons moving from firms sanctioned for fraud, and the need for additional supervisory conditions related to the use of introducing brokers.<sup>1/</sup> The Commission believes that this targeted approach effectively reviews SRO programs and directs the concentration of SRO efforts toward reducing the potential for sales abuses. In the Commission's view, a traditional checklist audit approach would not be more efficient and would not be more efficient and would not necessarily be more effective.

See pp. 21-22.

The Commission's staff devotes the greatest proportion of its sales practice oversight resources to review of the Chicago Board of Trade ("CBT"), Chicago Mercantile Exchange ("CME") and National Futures Association ("NFA") programs, which CFTC staff estimates are responsible for the review of sales practice compliance by firms accounting for more than 90 percent of customer sales activity. CFTC rule enforcement reviews of these SROs have been issued on an average of one every 1.4 years. Many of the New York firms assigned to the New York exchanges for sales practice audit purposes, and that are not also audited by the CBT or NFA for cause, have predominantly non-retail institutional, trade or market maker customers.

Our concern about the divergence between GAO expectations for the Commission's sales practice oversight program and the Commission's approach to the program is illustrated by the stated premise of the Draft Report. According to GAO, the Draft Report was undertaken in response to fraud allegations in enforcement actions brought by the Commission against two firms that were SRO members. The Draft Report states that these cases raised concerns about the adequacy of SRO oversight of sales practices.

See pp. 21-22.

In the Commission's view, this statement misses the point. The Draft Report reflects a misunderstanding of the integrated nature of our multi-program regulatory scheme of which SRO sales practice audits are only one component. Enforcement actions are one tool that the Commission uses to achieve customer protection and sales practice compliance. The Commission also has other regulatory tools that it uses to achieve these objectives, such as registration, sponsorship and competency testing of sales

See comment 2.

<sup>1/</sup> See, e.g., Rule Enforcement Reviews dated March 22, 1985 (NFA), September 14, 1988 (CBT), September 26, 1989 (NFA).

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professionals; consumer education; maintenance of a reparations system for customer redress which is an alternative to the courts and arbitration; oversight of SRO sales practice audit programs; and general rulemaking activities.

The CFTC's pending federal injunctive actions against the two firms, International Trading Group, Ltd. ("ITG") and the Siegel Trading Company, Inc. ("Siegel"), referred to by GAO allege primarily that salesmen misrepresented the profit potential of certain option contracts to potential customers by fraudulent and deceptive oral telephone and television sales pitches.<sup>2/</sup> Both injunctive actions were preceded by SRO actions. The allegations of oral and other misrepresentations made in the Siegel and ITG cases are of a type that have been identified to SROs in the Commission's rule enforcement reviews. Moreover, the Commission's rule enforcement reviews specifically identified the Siegel and ITG firms to the relevant SROs for further review. Accordingly, these cases are not evidence of a previously unidentified type of abusive practice.

Checklist audits would not have eliminated the need to take enforcement actions in these cases. The Commission believes that enforcement action must be used in addition to self-regulatory programs to achieve sales practice compliance. During a period when both the enforcement program and sales practice rule enforcement programs were in effect (1983 to 1989), futures and options trading increased by approximately 130 percent in the

<sup>2/</sup> On March 11, 1988, the Western Business Conduct Committee of the National Futures Association, the designated self-regulatory organization ("DSRO") for ITG, settled a case against ITG involving allegations of deceptive sales practices. ITG was fined \$90,000 and ordered to undertake certain enhanced compliance procedures. Also, on March 14, 1986, CFTC staff reported in a rule enforcement review that the CME, Siegel's DSRO, was requiring Siegel to send all options complaints to the CME's Audit Department within ten business days of receipt by the firm; to retain any tapes of conversations with customers for a minimum period of six months; to produce such tapes within five business days of a request by the Exchange; and to require Siegel to provide option customers with enhanced disclosure of the firm's commission policy. Pursuant to a September 19, 1989 settlement, the CME fined Siegel \$100,000 for exercising unauthorized discretion in selecting the strike price at which customer orders were to be effected and ordered it to comply with certain undertakings concerning options sales.

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United States and reparations complaints of all types fell from 916 in fiscal year 1983 to 247 in fiscal year 1990.

In the Commission's view, routine SRO audits are ordinarily directed at determining compliance with requirements concerning such matters as written disclosure, discretionary account documentation, order tickets, written promotional material, and reporting to customers. Such audits do not detect fraudulent sales tactics most often committed through multiple telephone communications as readily as do Commission enforcement or SRO investigations. Recognizing this, CFTC staff, in a letter dated August 30, 1989, recommended that the relevant SROs add sales practice investigations to their compliance programs. The CBT, CME and NFA have responded by establishing separate compliance programs which, as recommended, may employ investigative procedures, including interviews of complaining customers, SRO staff posing as potential customers of firms, interviews of a random sample of non-complaining customers, and interviews of sales personnel and supervisors of firms subject to investigation. Such procedures also target certain "high risk" firms for more intensive monitoring.

Further, the Commission has integrated its sales practice audit and financial oversight programs and has increased the audit staff committed to this program by two full-time positions in Fiscal Year 1991. The more comprehensive, less targeted approach to sales practice oversight envisioned by GAO would require that significant additional resources be committed to the program. Before substantially changing the Commission's present approach to our audit responsibilities, and further increasing resources devoted to this program, the Commission would have to assess what combination of oversight, enforcement and self-regulation would be the most effective in further deterring sales practice abuses. No one program is sufficient in and of itself.

As we have previously communicated to GAO, we believe that GAO's factual conclusions could be misleading in key areas, including SRO audit coverage of futures commission merchants,<sup>3/</sup> CFTC coverage of SROs and the scope and purpose of the CFTC's public reports on its rule enforcement reviews. Therefore, we believe that GAO's recommendations may be based upon flawed predicates.

<sup>3/</sup> For example, the Draft Report may be read to suggest that firms that received limited scope audits received no audit coverage whatsoever.

See pp. 21-22.

See comment 3.

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In some areas, such as refining the Commission's Sales Practice Interpretation No. 1 to address branch office coverage more comprehensively and better documentation of scope-setting and steps performed in an oversight review, we find GAO's comments to be constructive and intend to implement them. Nonetheless, we would note that CBT, NFA and CME conducted a total of 684 branch office and guaranteed IB examinations in 1987 and 1988. In other areas, we differ with the legal or policy assumptions underlying GAO's recommendations. Specifically, GAO recommends that the CFTC use its legal and regulatory authority to require SROs to adopt CFTC program recommendations. The Commission has the authority to enforce staff recommendations where such recommendations address specific statutory or regulatory deficiencies.<sup>4/</sup> Because staff recommendations often highlight areas where exchanges may wish to undertake program improvements rather than always identifying areas of deficiency, broad enforcement remedies may not be appropriate. In any event, SRO programs have paid serious attention to such recommendations.

See p. 22.

Further, those GAO recommendations that would require the Commission to monitor SRO compliance between rule enforcement reviews assume a fundamentally different approach to sales practice oversight than that which has historically guided the Commission's program. Implementation of such an approach would require substantial additional resources.

See p. 32.

Finally, GAO recommends that the Commission require NFA to adopt a rule requiring fair and reasonable commissions, without necessarily specifying precise amounts. Defining a specific level or even general guidance as to what is "fair and reasonable" in a rule would be a complex task that could have unintended anticompetitive effects. Moreover, a rule requiring fair and reasonable commissions may be circumvented by hidden mark-ups or other charges. Consequently, the Commission is not convinced of the policy merits of a rule regulating commission rates.<sup>5/</sup>

See p. 36.

<sup>4/</sup> Cf. In the Matter of the Chicago Mercantile Exchange, CFTC Docket No. 87-6 (CFTC January 23, 1987), in which the CME paid a \$100,000 fine and entered into undertakings concerning its financial compliance program. The matters that were the subject of this case were also the subject of a 1984 rule enforcement review.

<sup>5/</sup> See also, e.g., Johnson v. Fleck, CFTC Docket No. 88-R282 (CFTC November 20, 1990). (Commissioners West and Gramm concurring expressing different views regarding commissions and fees).



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The development of a rule enforcement program is an iterative process. Improvements have been made in the Commission's sales practice oversight program as the oversight program has matured and Commission staff has obtained additional expertise and experience. Further improvements can undoubtedly be made; all programs are amenable to improvement over time. The Commission is undertaking changes to the program generally and in response to GAO's Draft Report in the belief that they will improve the program. The Commission is committed to making additional changes whenever it is convinced that these changes will further improve the program. We appreciate the GAO's efforts to assist in this process.

Thank you for the opportunity to comment on your report.

Very truly yours,

Wendy L. Gramm  
Chairman

The following are GAO's comments on the Commodity Futures Trading Commission's letter dated December 6, 1990.

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## **GAO Comments**

1. CFTC noted that we did not review its sales practice program in light of the objectives the program was intended to meet. We agree with CFTC that the intent of the agency's program is to enhance retail customer protection by reviewing the effectiveness of SRO sales practice programs. Our evaluation was made on the basis of this understanding, and our recommendations were made with the objective of improving CFTC oversight of SRO program compliance.

2. CFTC noted that our report's references to recent allegations of fraud represent a divergence of expectations. The report's references to recent allegations of fraud are not intended as criticism of CFTC enforcement actions or its enforcement program. However, to avoid this misinterpretation of our expectations about CFTC's sales practice program, we have deleted references to recent instances of fraud where such misinterpretations might occur.

3. CFTC commented that it informed us earlier that some of our factual conclusions could be misleading and that, as a result, our recommendations might be based on flawed assumptions. We have made changes or additions to the report, where appropriate, to address these concerns. For example, CFTC agreed that the futures commission merchants mentioned in its response did not receive required full-scope sales practice audits, as indicated in our draft report. However, NFA officials noted that our report should reflect that these firms had received limited-scope audits. As a result, we clarified the text of the final report (see p. 27).

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