Walsh Agency

Initial Ethics Training

To complete this training, simply follow these instructions:

1. Read all the way through the text on this page.
2. At the very end of the page, there will be a blue button labeled “Sworn Declaration”. Click on the button.
3. Fill out the form carefully. Your certificate will be sent to the email you put in.
4. Click the button that says “Submit”.
5. If you are with either Americash or United Fidelity Funding Corp, click the button that matches. Otherwise click the button labeled “Click here to pay by credit card”.
6. Select the course that you completed from the list by clicking “Add to cart”.
7. Once the item has been added, a popup will show at near the top right, click the button that says “Checkout”.
8. Click the button that says “Checkout”.
9. Fill out your information and credit card information for processing.
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Initial Ethics Training

Please scroll through this course. No tests, no timers, no downloads. Move your mouse pointer to the arrow at the bottom of the vertical, narrow scroll bar at the right of this page. Left click mouse to scroll to the next page and repeat. On the last page, click the link to the Sworn Declaration (with Invoice), print, complete and send to us.

Welcome to **Initial** Ethics Training. This course is for registrants who have **not** previously taken ethics training and for those whose registration has lapsed.

The Walsh Agency, Inc., a Connecticut Corporation established in 1970, has specialized in training brokers who sell futures since 1976. We offer Sales, Ethics, Anti-money Laundering (www.anti-moneylaundering.com) and Trader Training. We have conducted more than 30,000 trainings for FCMs, IBs and APs including: ADMIS, FC Stone Group, Lind-Waldock, Merrill Lynch, MF Global, PFG, RCG, RJO, Smith Barney and Vision as well as the Chicago Mercantile Exchange, Kansas City Board of Trade, New York Board of Trade (now ICE) and several major FCMs.

We designed this newly formatted ethics course to be as painless and easy to take as possible. It’s created to be user-friendly. Everything is streamlined. There are no downloads, no Qs and As and no Social Security number or Credit Card number required to access this course, no worries about Internet Security breaches and identity theft. You may go through this material at your pace; there are no time restrictions, no clocks, no quizzes and no tests.

Introduction

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7. Free manual ***How to Trade Futures***

Provider

The Walsh Agency has specialized in training APs and brokers who sell futures, including managed accounts and funds, since 1976.

Several brokerage firms (FCMs and IBs) and Commodity Exchanges have retained us to survey prospects, clients and brokers to determine the most effective methods for finding, opening and retaining accounts. This research shows **the number one attribute prospects want in a broker is honesty, which is synonymous with good ethics.**

The Walsh Agency, Inc. is an authorized Ethics Training Provider – by the National Futures Association. The National Futures Association (NFA) and the Commodity Futures Trading Commission (CFTC) have not read or approved the content of this ethics training. As a matter of policy, the NFA and the CFTC do not read or approve any Ethics Training Courses. As part of the research to develop this course, we conducted in-person interviews with the CFTC’s Ethics Staff in Washington, D.C. and the NFA’s Ethics Staff in Chicago. This course covers all the topics required by the regulators. We designed this course to help keep registrants well in compliance and out of trouble.

Instructor

John Walsh has been working with brokers who sell futures for almost thirty-five years. In this ethics course, he shows you how practicing good ethics and obeying the law can actually help you increase your business. He has written several books about futures including ***How to Sell Futures***, ***How to Raise Managed Money and Sell Futures Funds***, ***Ethics Training Manual for Futures Professionals*** and ***Master Brokers***, a book of interviews with top APs. Many are quoted throughout this course.

Course Description

The Commodity Futures Trading Commission’s regulation 3.34 Mandatory Ethics Training reads in part “…registrants must attend ethics training to ensure that they understand their responsibilities to the public under the act including responsibilities to observe just and equitable principles of trade, rules and regulations of the Commission, rules of any appropriate contract market, registered futures association, or other self-regulatory organization or any other applicable federal or state law, rule or regulation.”

Since the requirement is all about rules and regulations, our ethics training is all about rules and regulations. We designed our courses to teach registrants the law, to help keep themselves, their supervisors, and the officers and owners of their companies in compliance and out of trouble and to conduct themselves ethically.

To be certain our courses teach the best information to meet these objectives, we conducted in-person interviews with the regulators mentioned earlier. We also met with more than twenty key compliance people from major brokerage firms, Commodity Pool Operators and Commodity Futures Exchanges. We asked them what they looked for to make sure registrants were complying with the law and acting ethically. We asked them what are the most common violations as well as the most serious. They gave us literally hundreds of examples. We thank them for their help.

Everything in this course is based on facts. The examples and case histories came from our surveys of regulators, compliance officers and the following sources:

1. The Commodity Exchange Act as amended and regulations there-under
2. The CFTC’s Proceedings Bulletin
3. CFTC Annual Reports
4. The National Futures Association (NFA) Manual
5. The National Futures Associations’ Interpretive Notices
6. NFA’s Regulatory Guide for FCMs and IBs
7. NFA’s Regulatory Guide for CPOs and CTAs
8. NFA’s Reports of Quarterly Actions
9. The NFA’s Self-Examination Checklist
10. Various commodity and security law reports
11. The Federal Register

‘Take a break’ from this course and return

You may easily navigate quickly through this course. Each page is numbered. If you want to take a break, you’re welcome to do so. Just make a note of the page where you left off and return to it at your convenience.

Sworn Declaration and Invoice

This is the form you’ll fill out at the end of the course. The link to it is at the end. Fill in the information requested: name, address, etc. (no SS # requested or required). After that, there will be the invoice and checkout.

The invoice is after the completion of the Sworn Declaration. We accept American Express, MasterCard, Visa, Money Orders or checks.

Please be sure to keep a copy of your Certificate of Compliance in your files, as required for your firm, your FCM, for your personal records and in the event of an audit.

Certification and your Professional Ethics Certificate – suitable for framing

Upon receiving your completed Sworn Declaration worksheet and payment, we certify you and send you a copy of your Ethics Certificate which is suitable for framing. Many brokers do frame their certificate and display them in their office.

Each certificate lists the ten subjects which the regulators require to be included in every ethics course. It also shows the date you were certified. Be sure to keep a copy of your Certificate in your files as required and in the event of an audit.

Your Certificate, not your Sworn Declaration, is your proof to your company and any auditors that you successfully completed this Initial Ethics Training Compliance course.

Free tutorial, *How to Trade Futures*

The price of this ethics course includes a free copy of ***How to Trade Futures.*** It’s available for printing and/or reading at the end of this course.

For almost thirty-five years, we’ve surveyed thousands of brokers, traders, Commodity Trading Advisors and Floor Brokers by phone, focus groups, email, snail mail, in-person, industry meetings and discussions at seminars. Funding of $200,000+ was provided by CME, KCBOT, NYBOT (now ICE) and many FCMs.

How to Trade Futures shows you precisely how successful traders trade. Professional educators told us the most effective way to do this is to let you read (rather than tell you) the most relevant quotes from the responses of experienced futures brokers and traders. That way you can decide for yourself if you want to try what works for them. They tell you, in their own words, their proven strategies and rules for successful trading and **how they avoid margin calls and deficits**.

This Initial Ethics course is divided into the following sections:

1. Communications with the Public
2. Financial Situation and Investment Experience of Prospects and Customers
3. Disclosure of Material Information
4. Sales Practices
5. Acting Honestly and Fairly with Due Skill, Care and Diligence in the Best Interest of the Customers and the Integrity of the Market (Part I)
6. Acting Honestly and Fairly with Due Skill, Care and Diligence in the Best Interest of the Customers and the Integrity of the Market (Part II)
7. Conflicts of Interest and Confidentiality
8. Managed Money: Including Responsibilities of Commodity Pool Operators and Commodity Trading Advisors
9. Supervision and Internal Controls
10. Review and Summary

Communications with the Public:

These rules pertain to your: advertising, direct mail, newsletters, letters, short notes, seminars, workshops, speeches, interviews, e-mail, web site, adult education classes, phone solicitations, one-on-one or group presentations, trade shows, magazine and newspaper articles, etc., virtually everything you communicate to clients and prospects.

While this list may seem long, it protects the public and you. It’s not necessary to memorize the list, just remember, any communication to any prospect or client is subject to scrutiny. Be aware, anything you communicate that is not in compliance can get you and your firm in trouble, possibly serious trouble.

For example, imagine yourself jotting a quick note to a client about a fund you are selling. You mention this fund gives his portfolio balance and is a hedge against a down market. If the fund does not perform, your note could be used against you in a court of law, arbitration hearing or at an NFA Business Conduct Committee (BCC) hearing…if you did not include the “risk” side of the story.

We asked a thirty year veteran broker his thoughts about this subject and he said, “Before I send anything to a client or prospect, I ask myself, how would this look to an Administrative Law Judge if the client or prospect decided to sue?” He said he wasn’t being paranoid, he was only being realistic; “in today’s litigious environment everybody’s suing everybody.”

According to the National Futures Association’s (NFA) Interpretive Notice 9003, the rules and regulations about communications with the public do not apply to your routine day-to-day communications with your customers as long as they:

- Are not fraudulent or deceitful.
- Are not high pressure.
- Do not contain any statement that futures trading is appropriate for all persons.

Sales promotion literature is an area that has seen many violations over the years. The NFA's Reports of Quarterly Actions lists the names of individuals and firms who have been temporarily or permanently barred from the futures industry. In more than 75% of these cases, deceptive and misleading promotional literature was listed as one of the reasons for disbarment.

The regulators and your compliance department have reviewed literally hundreds, possibly thousands, of types of promotional literature over the years. They are constantly on the lookout for violations. They've seen it all. Don't try to put something past them. If you do, it could cost you your job, possibly more.

According to our survey of compliance officers and regulators, some of the more important requirements for promotional literature are:

- Information must be factual.
- You must be able to document any and all claims.
- You must balance any statements about profit potential with statements of risk of loss.
- Any reference to hypothetical results must be accompanied by a specific statement required by the NFA.
- Any statement of actual past trading profits must be accompanied by a statement that past performance is not necessarily indicative of future results.
- Opinions must be identified as opinions and have a reasonable basis in fact.
- The most important thing compliance people and regulators told us about promotional literature is that you must get anything and everything reviewed and approved by your supervisor and/or compliance department before you send it. The review, as well as the approval, of promotional literature must be in writing. One of the surest and fastest ways to get in trouble with your supervisor, and your compliance department and your company would be to send or present anything to your prospects and clients without this prior written review and written approval.

As mentioned earlier, interviews, such as those with the media, can be considered communications with the public if they are used to solicit business (and what interviews aren't?). Most compliance officers we spoke with said they do not want their brokers and or APs to be interviewed by anyone.

Here is an example given to us by a senior compliance officer of a major FCM.

"One of our brokers is being interviewed on TV about trading techniques. Our broker states that while in our orientation program, he was taught to always use stops. In fact, he says he was trained to enter the stop when he entered the order. Someone watching this interview is a client of an AP with one of our GIBs. The broker also went through our orientation program, but he never uses stops. That person watching the interview may feel he has a case against us. After all, his broker was taught to use stops but he never did and that person lost money because of it."

There are many other pitfalls for brokers giving interviews. An equity broker who sells funds tells an interviewer how a futures fund can give balance to a portfolio, improve returns, and reduce volatility. He fails to mention that futures funds are not for everyone. He does not mention downside risk. If a dissatisfied investor in one of his company's funds saw that interview, the broker and his/her firm could be at risk. It is relatively easy for lawyers to get videotape copies of such interviews or audiotapes of radio interviews.

In summary, most compliance officers we interviewed say the risks outweigh the rewards when media interviews are concerned. Often a broker will see an article in a newspaper or magazine that agrees with the broker's thinking about a certain trading opportunity or about the advantages o managed futures. If a broker sends a copy of the article to a prospect or client there may be a potential problem. This third party endorsement has the possibility of strengthening the broker's rationale as to why the prospect or client should put on the trade or buy the fund. People seem to give added credence to something if they read or see it in the media. Much of the time these stories are biased and do not necessarily present both sides of the story. Often they do not mention any downside risk at all. The regulators have a problem with brokers sending out this kind of "one-sided" information with no additional statements to give balance to the article. In fact, to quote from the NFA's Regulatory Guide for FCMs and IBs, "it is safe to assume that the use of an article, without some type of accompanying explanation, will be unacceptable."

The rule of the day for you on this topic must be: before you send out any article or copy thereof, check with your supervisor and/or compliance department.

The NFA is not only very serious about the written review and written approval of all promotional material, but also about record keeping.

The NFA requires that all promotional material, along with the record of its review, be kept on file by the member of the NFA. This material must be readily accessible for two years from the date of its last use and, as with other required records, be maintained for at least five years altogether.

Brokers often use their past trading results in promotional material to show the effectiveness of their (or others') trading plans. Brokers may not select certain futures contracts traded or certain time periods solely for the purpose of improving their track record. The regulators call this 'cherry picking' which is prohibited. Any results the broker features must be representative of the broker's overall performance with similarly traded accounts. Any presentation of performance must include the statement that past performance is not necessarily indicative of future results.

Brokers must also be particularly careful when giving their opinions in promotional material. To quote from NFA Rule 2-29(d), "Statements of opinion included in promotional material must be clearly identified as such and must have a reasonable basis in fact." You must also be able to document the basis for your opinion(s) if called on to do so by the regulators or your compliance department.

Occasionally, brokers overlook the fact that a research report is a form of communication with the public. Research reports require a disclaimer. Here is a sample:

RESEARCH DISCLAIMER

These opinions can be a valuable addition to the investment or hedging goals of our readers. Investors are reminded of the inherent risks associated with trading futures contracts much like any leveraged investment vehicle. This is not a solicitation of any order to buy or sell, but merely a current market bulletin. Any statement of facts herein contained are derived from sources believed to be reliable but are not guaranteed as to accuracy, nor do they purport to be complete. No responsibility is assumed with respect to any such statement or with respect to any expression of opinion herein.

Two of the objections some prospects have about trading futures are the possibility of margin calls and unlimited risk. To counter this objection many brokers sell options on futures and tell prospects that options have no margin calls and have limited risk. This statement is a violation of the National Futures Association's "Communications with the Public" rules for two reasons. 1. Touting limited risk without explanation is likely to mislead the public unless the broker explains the risk is limited to the entire amount the client paid for the long option. 2. Some options do indeed have the possibility of margin calls and their risk of loss goes beyond the price the client paid for the option.

Another area where brokers have violated the NFA's communications rules is stating that futures enable the investor to "control a large amount of a commodity with a small amount of money." The broker may not use the term "control" to explain that an option will enable the client to benefit in full from a favorable price movement in the underlying futures contract. Why? Because options do not necessarily move in lock-step with their underlying futures contract.

NFA's Rule 2-29 prohibits any communication that results in high-pressure selling. "Don't ever talk anyone into trading futures, if you do, you'll live to regret it." This advice comes from some of the best and most experienced compliance officers and APs in the futures industry. Their comments apply to selling managed futures as well as trading accounts.

High pressure selling can get you in trouble with your compliance department and regulators. The NFA Regulatory Guide states, "if found guilty of high-pressure selling, you will be dealt with swiftly and severely!"

According to the NFA's Guide for FCMs and IBs, some of the tactics of high-pressure selling include:

- Overstating profit potential.
- Understating risk of loss.
- Pressure to invest immediately.
- Constant telephone calls (often daily).
- Overstating expertise by the person making the recommendation.
- Unavailability of the broker after the sale is made.

To repeat, high-pressure selling can get you in a lot of trouble fast. Don't do it!

Reporting a CTA's annual returns may require additional disclosure if the results could be misleading. For example, if a CTA had an annual return of 20%, yet experienced many, or even a few, monthly fluctuations of 60%, certainly this disclosure would be required.

The vast majority of people we surveyed suggested you tell prospects about the possibility of losses first. They said the tendency of many brokers, especially new ones, was to oversell the opportunity to make money and downplay the possibility of losing money. They observed the more experienced brokers in their firms used a conservative sales approach in their communications with the public – whether it be in-person or via sales literature. Many experienced brokers explain to prospects and clients that part of the reason for the possibility of substantial profits is because of the leverage available in futures. These brokers then explain that leverage is also the reason for the possibility of substantial losses. APs who do not give equal balance to profit potential and risk of loss are sowing the seeds of lawsuits.

Additional Rule 2-29 guidance from the National Futures Association

Radio and Television Advertisements

No Member shall use or directly benefit from any radio or television advertisement or any other audio or video advertisement distributed through media accessible by the public if the advertisement that makes any specific trading recommendation or refers to or describes the extent of any profit obtained in the past that can be achieved in the future unless the Member submits the advertisement to NFA's Promotional Material Review Team for its review and approval at least ten days prior to first use or such shorter period as NFA may allow in particular circumstances.

NFA INTERPRETIVE NOTICES

Use of On-Line Social Networking Groups to Communicate with the Public

On-line social networking groups have changed the way people make trading decisions. A number of NFA Members sponsor blogs, chat rooms, and forums (also called message or bulletin boards), and some use sites like Facebook or Twitter for business purposes. Associates may also sponsor or participate in these groups. Unfortunately, these on-line communities provide opportunities for posters to spread unsubstantiated rumors and intentional misrepresentations. The form of communication does not change the obligations of Members and Associates who host or participate in these groups, and electronic communications. They must comply with Compliance Rules 2-9, 2-29, 2-36 and 2-39.

Obviously, any electronic content that can be viewed by the general public, or even by a more closed community that includes current and potential customers, can be promotional material. For example, blogs dealing with commodity futures or options are promotional material when written by an NFA Member or Associate, and forex blogs are promotional material when written by a Member or Associate subject to the forex rules. Therefore, content generated by the Member or Associate is subject to the requirements of NFA Compliance Rules 2-29, 2-36, or 2-39. The same is true for futures, options or forex content written by a Member or Associate and posted on a third party's site.

The issue becomes more complicated for user-generated comments responding to a Member or Associate's blog and for Members and Associates who host chat rooms or forums. What is their responsibility for posts from customers or others over whom the Member or Associate has no direct control? When inadequately monitored, social networking sites may contain misleading information, lure customers into trades that they would not normally make or be used in an attempt to manipulate prices.

If a Member or Associate hosts a blog, a chat room, or a forum where futures or forex are discussed, the Member or Associate is required to supervise the use of that community. This requires, at a minimum, that the Member or Associate regularly monitor the content of the sites it hosts, tak down any misleading or otherwise fraudulent posts and ban users for egregious or repeat violations. Not only are these actions required by NFA's supervision rules, they are both common sense and common practice. Similar requirements apply to Facebook and other sites that allow others t post to the Member or Associate's "wall" or other assessable area.

Audio podcasts and videos on the Internet – whether on the Member's or Associate's Web site or on an independent site such as YouTube – are similar to radio and television advertisements. If they make specific trading recommendations or refer to profits that have been obtained in the past or can be achieved in the future, NFA Compliance Rule 2-29(h) requires the Member or Associate to submit them to NFA for approval ten days prior to use.

Members should have policies regarding employee conduct. These policies could require employees to notify the employer if they participate in any on-line trading or financial communities and provide screen names so that the employer can monitor employees' posts periodically. Alternatively, the policy could simply prohibit participation in such communities. The Member must, of course, take reasonable steps to enforce whatever policies it adopts.

The interpretive notice also states that Members are responsible for supervising their employees and agents who decide whether to include a hyperlink to another web site. While Members are not necessarily accountable for the content on the hyperlinked site, they are responsible for monitoring that content and removing the hyperlink if they have reason to believe the content is misleading. This includes hyperlinks to third-party blogs, chat rooms and forums.

EXPLANATION OF AMENDMENTS

In December 2008, NFA's FCM, IB, and CPO/CTA Advisory Committees considered the growing use of social networking groups such as blogs, chat rooms, and forums to communicate with and solicit customers. As a result of those discussions, all three committees felt it would be helpful to issue written guidance reminding Members of their responsibilities in connection with these on-line communications.

As part of the process, NFA staff reviewed FINRA's response to the same issue. FINRA guidance states that blogs and bulletin boards are considered advertisements and are subject to the same requirements as other advertisements, while participating in a chat room is a public appearance subject to those rules. The guidance also states that "Member firms must supervise the operation of any securities related blog, bulletin board or chat room hosted by an RR or by the firm itself to ensure compliance with FINRA Conduct Rules and the federal securities laws." The guidance also reminds members that their supervisory procedures can prohibit employees from using electronic media to discuss securities investments if the firm decides the medium is too hard to supervise.

FINRA has also produced several podcasts discussing on-line communications. In one podcast, FINRA staff suggest limiting posting access to a firm's blog or bulletin board to the firm's registered representatives. If the firm opens it up to a wider audience, however, the podcast advises requiring users to register and agree to the firm's terms of use. In another podcast, FINRA staff state that publicly available social networking sites are advertisements and those with restricted access are sales literature, subject to the same content, pre-approval, filing, and recordkeeping requirements applicable to other advertisements and sales literature.

NFA has prepared an Interpretive Notice that is similar to the FINRA guidance. The Notice reminds Members that on-line communications are subject to the same standards as other types of communications. On a related issue, NFA compliance staff has noticed that the profit claims that used to appear on radio and television are moving to the Internet and showing up on sites such as YouTube. Therefore, the amendments to Compliance Rule 2-29(h) require that these videos – like similar radio and television advertisements – be submitted to NFA in advance for review and approval.

As mentioned earlier, NFA is invoking the "ten-day" provision of Section 17(j) of the Commodity Exchange Act. NFA intends to make the amendments to NFA Compliance Rule 2-29(h) and the related Interpretive Notice effective ten days after FINRA February 23, 2009 podcast on "Electronic Communications: Blogs, Bulletin Boards and Chat Rooms,"

The proposed adoption of the Interpretive Notice became effective on December 24, 2009, and the proposed amendments to Compliance Rule 2-29(h) became effective as of February 1, 2010.

9037 – NFA COMPLIANCE RULE 2-9: SUPERVISORY PROCEDURES FOR E-MAIL AND THE USE OF WEB SITES
INTERPRETIVE NOTICE

NFA Compliance Rule 2-9 requires Members and Associates with supervisory duties to diligently supervise employees and agents in the conduct of their commodity futures activities for or on behalf of the Member. The rule is broadly written to provide Members with flexibility in developing procedures tailored to meet their particular needs. On certain issues, however, NFA has issued Notices to Members to provide more specific guidance on acceptable standards for supervisory procedures. Currently, information technology is changing nearly every aspect of how Members conduct business, including how they communicate with their customers. For example, e-mail and internet-based communications have enabled Members and their employees and agents to communicate with customers more frequently and efficiently. Expanded use of this technology, however, also requires Members to re-examine their methods of supervising their communications with the public.

This Notice addresses the supervisory issues raised by use of e-mail and web sites to conduct futures-related business. Although this Notice does not specifically address every aspect of electronic communication, such as the use of chat rooms to conduct business or after-hours electronic trading activity, this is not intended to suggest that Members have no supervisory obligations regarding these types of activities. Consistent with the approach taken in this Notice, in establishing supervisory procedures for electronic communications, Members may wish to draw from their experience in supervising non-electronic communications.

E-Mail

A Member's duty to supervise the use of futures-related e-mail by its employees and agents is basically the same as its duty to supervise other forms of correspondence. NFA would expect each Member to adopt review procedures that are appropriate in light of its business activities, including the structure, size and nature of its business operations. Like other supervisory procedures, a Member's supervisory procedures with respect to e-mail must: be in writing and identify by title or position the person responsible for conducting the review.

In addition, firms may wish to consider whether the following procedures would be appropriate as well:

- specify how and with what frequency e-mails will be reviewed and how that review will be documented; and
- categorize what type of e-mail will be pre-reviewed or post-reviewed.

Each Member is free to adopt the specific procedures that it will use to conduct its review. However, those procedures must take into consideration the nature of the communication, the relative sophistication of the recipient and the training and background of the employees and agents. In some instances, spot-checking or sampling e-mail messages representing routine communications between employees or agents and existing customers may be appropriate and in others it may not. For example, a firm dealing with sophisticated or institutional customers might choose to sample a relatively small but representative amount of the routine electronic correspondence to review. On the other hand, firms dealing with individual, relatively unsophisticated retail customers might consider using a larger sample or even reviewing all the routine e-mail. Similarly, a firm may wish to conduct a comprehensive review of employees' and agents' e-mail if they have a disciplinary history involving problems with customers or came from a firm that has been disciplined for fraud.

Members' procedures should also address whether employees and agents are permitted to use e-mail systems other than the firm's system. If a firm permits them to use other systems for business purposes, whether on their work or home computer, the firm's procedures must treat these off-system e-mails as its own records and must ensure that the firm is capable of adequately reviewing them.

Given the supervisory problems which could arise, some firms may choose not to permit their employees and agents to communicate with the public outside of work through an e-mail system that is not linked to the firm's network. (sic)

In many instances e-mails may constitute promotional material. E-mail directed to the public soliciting business constitutes advertising and is subject to the same rules as any other form of promotional material. For example, an e-mail message sent to targeted individuals or groups would be considered promotional material if its ultimate purpose was to solicit funds or orders. A Member's e-mail review procedures must be designed to ensure compliance with NFA's promotional material content and review requirements. These requirements, found in NFA Compliance Rule 2-29 provide, among other things, for prior review of this type of e-mail by appropriate supervisory personnel. Additionally, this type of e-mail is subject to the specific recordkeeping requirements of Compliance Rule 2-29.
Members should properly educate and train their employees and agents on the firm's policies regarding e-mail communications – particularly on those communications that are not reviewed by supervisory personnel prior to use. Special attention should be given to those employees and agents with previous compliance or disciplinary problems. Finally, Members must periodically evaluate the effectiveness of their e-mail review procedures and modify them as necessary.

Web Sites

Both Members and their employees and agents can inexpensively and quickly create web sites to attract business. NFA's Compliance Rule 2-29 establishes the standards that web site content must meet. The procedures that Members adopt to supervise the use of web sites must be designed and enforced to ensure that the web sites comply with these standards. These supervisory procedures must: be written; require prior review and approval of the web site by an appropriate supervisor; and require documentation of the review.

Because the substantive content of web sites can change frequently, the Member's procedures should address how it will ensure that each substantively new version of a web page will be subject to the review procedures. Members' review procedures should address features unique to electronic communications, e.g., streaming script containing real-time market news, for which neither prior review nor post-review of each bit of information may be possible.

Unless the web site limits access to a particular target audience, through an acknowledgment by the user or other means, the Member's review procedures should take into consideration the fact that the web site, like other forms of mass media advertising, is available to the public at large. If the firm permits its employees and agents to use personal web sites to attract business for the firm, these web sites will constitute firm promotional material. Consequently, the Member's procedures must be adequate to enable it to properly review the employees' and agents' web sites, including all substantive modifications, according to its procedures. Additionally, to ensure compliance with the recordkeeping requirements, the firm's procedures should provide the means to identify the time frame in which particular versions of the web page are in use. Finally, Members must periodically evaluate and modify as necessary their web site review procedures to ensure their effectiveness.

As is the case with other media, the use of agents' web sites to solicit leads may subject a firm to liability if the agents' leads were generated through deceptive materials posted on a web site. If a firm (either non-Member or Member) maintains a web site which contains deceptive information regarding futures or options trading and a Member pays that firm to provide a hyperlink to the Member's web site, the Member may well be held accountable for the content of the other firm's web site.

The fact that a Member creates a hyperlink from its web site to another web site does not, in and of itself, make the Member firm accountable for the content of the other web site. Member firms should bear in mind, though, that their supervisory obligations under Rule 2-9 and Rule 2-29 require them to diligently supervise their employees and agents who are responsible for creating and maintaining the web sites, including hyperlinks to other web sites. Members should consider whether appropriate supervisory procedures include periodic inquiries as to whether their employees and agents are monitoring the general content of the web site to which the Member links. NFA is not suggesting that firms are necessarily responsible for the virtually infinite chain of links from its web site to others. At the same time, Members who seek to circumvent NFA promotional material and supervision rules by using a chain of hyperlinks to a "remote" web site may be held accountable for that "remote" web site's content.

Financial Situation and Investment Experience of Prospects and Customers

Assessing the financial situation and investment experience of your prospects and clients is one of your most important responsibilities. You are required to profile your prospects. As you have heard before, "futures trading is not for everyone." Of course, the degree of involvement and the type of futures trading must also be taken into consideration.

If you are a securities broker selling funds to your current clients, your job of profiling may not be as rigorous as a futures broker prospecting a new client. You already know the financial situation and investment experience of most, if not all, of your clients. You know that putting $25,000 into a fund might be appropriate for a $500,000 stock and bond portfolio you are managing. You also know that putting $25,000 into a fund would be inappropriate for a $50,000 portfolio.

However, if you are a newer futures broker soliciting trading accounts, this section describes the land mines and pitfalls many brokers before you have encountered. Most of them avoided these problems. Some did not and have been either sanctioned or barred from the industry.

We mention newer brokers because if you are a transactional broker taking this Initial Ethics Training Course, you have been a broker a maximum of six months. Even if you are an experienced equities broker, the material in this section can also help keep you out of trouble.

Many problems that occur for newer futures brokers come from accounts that should never have been trading futures in the first place. It is your job to attempt to determine if your prospect should become your client.
Let us look at investment experience first. Many times, financially unsophisticated prospects are intrigued by some news about a pending drought or whatever. Let us assume, for a moment, you are prospecting and find one of these neophytes. You hard sell her into putting $5,000 in the corn market. She is thirty years old, single, annual income $25,000, net worth $100,000 and has never traded futures, in fact, has never invested in anything. How is this client going to react to margin calls, locked-limit moves, missed stops, losing $1,000 the first week or losing more than her original investment?

How about an older couple? They have no investment experience of any kind. They barely meet your company's minimum financial suitability requirements. They have heard bullish news about gold. However, they do not like the unlimited risk aspect of trading futures. You talk them into buying several deep out-of-the-money options.

What do you think would happen if you opened clients like these and they decided to sue you and your firm? You have to counter their claims of, "We never invested in anything before; we really didn't understand what was going on." Never mind that these clients had signed the Risk Disclosure Statement; it is likely you would still lose.

To quote from part of the NFA's interpretive notice 9013, "… a number of the more egregious cases, (listed in the National Futures Association Manual) which have generally resulted in expulsions from NFA membership, are summarized below. The exact factual circumstances vary from case to case, **but one common thread in these cases is the customer had no previous futures trading experience, and little, if any, other investment experience."**

Therefore, a prospect who has never traded futures and has little or no previous investment experience is a potential time bomb. Consider this situation as a red flag and consult your manager as to whether or not you should accept this kind of account.

Another problem area concerning financial situation is falsifying information on the account opening forms. From time-to-time, newer, as well as experienced brokers, have "guided" their clients to stretch the truth about income and net worth.

Some examples of these violations, from the National Futures Association Manual, where the broker was usually expelled from the industry, include:

- A broker told a 42 year-old retiree to inflate his net worth high enough to get his account approved.
- A broker told a prospect to include the value of his illiquid pension plan in his liquid net worth.
- A broker told a factory worker to exaggerate the amount of his liquid assets from $20,000 to $51,000.
- A broker advised an unemployed prospect to put down what his income was before he became unemployed.

Several compliance officers surveyed for this program spoke emphatically about the dangers of inflating income, net worth and other financial suitability factors. They said when clients, who failed the financial suitability test, sue, the firm generally ends up writing a check to cover the client's losses. If this happens, what do you think is going to happen to you? Again, it does not help if the client signed the Risk Disclosure Statement. In most of these cases you could still lose.

Here are three final examples, also quoted from the NFA manual, interpretive notice 9013, in which the member generally was barred from the industry.

"A broker solicited a 32 year-old nurse and her husband, a 39 year-old computer operator, neither of whom had any prior investment experience in commodities or securities. The customers repeatedly informed the broker that they could not afford a minimum required investment of $10,000. The broker told them to take out a loan from their credit union and that the required investment amount would then be reduced to $5,000. The customers subsequently took out a $3,000 loan from their credit union and added $2,000 from their savings account to meet the $5,000 minimum investment requirement. The husband then went to the firm's office and signed the account forms during his 30-minute lunch break. However, he did not read the forms, nor were they explained to him by the firm or broker."

"A customer who had been unemployed for two years, with a net worth of $30,000 derived from an inheritance and sale of property and no futures trading experience, was instructed by a broker to 'put down anything' on the account opening form regarding her employment and income. The customer received only the standard Risk Disclosure Statement. The broker neither explained the account documents to the customer, nor gave her sufficient time to review them."

"A broker solicited a 77 year-old retired real estate investor with a net worth of $100,000 and a fixed annual income of $20,000. The customer informed the broker that both he and his wife were in ill health and that one of the reasons for his interest in investing in commodity futures contracts was his limited health insurance coverage and a desire to earn enough money to pay for his medical expenses. Rather than providing the customer with risk disclosure in addition to that contained in the Risk Disclosure Statement, the broker informed the customer that the risk of loss involved in futures trading was slight."

The National Futures Association Manual continues, "Again, these cases summarized here illustrate some of the more serious violations of the Rule involving either inadequate risk disclosure or inducing customers to provide false information on their account opening forms. However, because determination of whether additional risk disclosure is required for a given customer can be made only on a case-by-case basis, these scenarios should not be interpreted to limit the circumstances under which additional risk disclosure may be required."

In many cases, a client's financial situation and investment experience could require additional risk disclosure in addition to the Risk Disclosure Statement. Again, this would include, but not be limited to, younger clients, older clients, clients with little or no investment experience, clients with questionable employment situations, clients who have never traded futures, clients who barely meet your firm's minimum financial requirements. If there is any doubt as to whether or not a client requires additional risk disclosure beyond the Risk Disclosure Statement, consult your supervisor.

Another vulnerable area is a language barrier between you and your clients. When you are assessing a client's financial situation and investment experience, if there is any possibility you do not understand your client or your client does not understand you…you are on thin ice.

These clients certainly can make themselves understood in a courtroom. Often, when a language barrier exists, you may think the client understands because of his apparent agreement, in spite of his failure to ask for clarification. This presumed agreement may stem from embarrassment rather than from understanding.

Even though you put everything in writing and have your client sign it, this may not be an adequate defense. If your client does not fully understand your spoken words, it is reasonable to assume he may not understand your written words. This is another one of those areas where you should consult your manager before you open the account.
Equity brokers who are selling funds and managed accounts are also subject to the same rules and regulations regarding financial situations and investment experience as transactional futures brokers.

The American Association of Individual Investors reports their number one source of complaints comes from people who say they were talked into inappropriate investments. Futures including funds are not for everyone.

Some compliance officers told us that brokers need to be aware of their prospects' financial situations even after they become clients.

A client's financial situation may change quickly and dramatically. For example, if a client begins to trade wildly and incur large losses, you must try to determine what's going on. Is the client in financial trouble and trying to use the futures markets to recover? Is the client going through a personal crisis? Is the client now losing necessary capital rather than risk capital? An experienced regulator told us a client's psyche may be as important as his financial situation.

Many experienced brokers condition their clients ahead of time to trade conservatively. They want to see how a new client reacts to a sudden loss or gain. Some clients are not suited for futures trading regardless of how much money or investment experience they have. They simply do not have the emotional make-up. The sooner you find this out in the relationship, the better. Then you may decide to resign these accounts. Many top brokers who sell futures, including managed futures, resign accounts.

When it comes to exchange traded options on futures contracts, the financial situation and investment experience of your prospects may require additional examination. CFTC Regulation 33.7 says in part, "commodity options transactions are not suitable for many members of the public."

The CFTC has stated that: "…the FCM must acquaint itself sufficiently with the personal circumstances of each option customer to determine what further facts, explanations and disclosures are needed in order for that particular option customer to make an informed decision whether to trade options…While this requirement is not a "suitability" rule as such rules have been composed in the securities industry, before the opening of an option account the FCM has a duty to acquaint itself with the personal circumstances of an option customer."

Your activities pertaining to the topic of this section are covered by the National Futures Association's Rule 2-30: Customer Information and Risk Disclosure. Following this rule helps you to get to know your customer. Every compliance officer and regulator we surveyed said the most important aspect of this section is, "know your customer."

The risk disclosures, as provided for under Rule 2-30, shall, at the very least, be:

- The standard Risk Disclosure Statement for futures traders
- Additional disclosures documents as required
- The Options Disclosure Statement as required

Be aware of the possible requirements for additional risk disclosure. It is important to note these risk disclosures are designed to bring the "suitability for trading" issue to the customer's attention.

Amendments to NFA Compliance Rule 2-30 and its related Interpretive Notice are effective as of January 3, 2011. Rule 2-30 requires NFA Members and Associates to obtain information about their futures customers and provide such customers with appropriate risk disclosure prior to the time the customer first opens a futures trading account or authorizes the Member to direct trading in their account. Generally, the amendments broaden the scope of the rule through the following changes:

- Expanding the customers covered by the rule to reach not just individual customers but all non-ECP (eligible contact participant) customers;
- Requiring FCM Members to annually request that active customers notify the Member of any material changes to the information obtained from the customer pursuant to Compliance Rule 2-30(c), and requiring the FCM, IB or CTA Member that currently solicits and communicates with the customer to determine if additional risk disclosure is required to be provided based on any changed information; and
- Prohibiting Members and Associates from making individualized trading recommendations to those customers whom the Member or Associate has or should have advised that futures trading is too risky for them.

The annual update (as of 1/3/11) process only applies to active customers. An active customer is defined as any customer who was entitled to a monthly account statement under the provisions of CFTC Regulation 1.33(a) at any time during the preceding year.

The FCM that carries the customer account will be required to contact the customer in writing at least annually to request that the customer notify the Member of any material changes to the information previously obtained. Members or Associates may contact the customer electronically or by any other means reasonably designed to reach the customer.

If a customer informs the carrying FCM that he/she is unable to verify the information because the information previously provided to the carrying FCM is not currently available to the customer, then the carrying FCM must promptly provide the information to the customer.

If the customer does not inform the carrying FCM of any material changes to the information, then the information previously provided is deemed verified. However, if a customer notifies the FCM of material changes to the information, a determination must be made as to whether additional risk disclosure is required based on the changed information. If another FCM or IB introduces the customer's account or a CTA directs trading in the account, then the carrying FCM must notify that Member of the changes to the customer's information. The Member or Associate who currently solicits and communicates with the customer is responsible for determining if additional risk disclosure is necessary.

We close this section on financial situation and investment experience of your prospects and customers as we began: "futures trading is not for everyone."

Disclosure of Material Information

Following the guidelines in this section will increase your chances of getting more business.

In Section One, communications with the public was covered. Section Two reviewed many of the rules pertaining to the financial suitability and investment experience of your prospects and clients. Now begins the process of disclosing the material information necessary to help each prospect decide if managed futures or futures trading is for him/her. Your very action of disclosing material information openly and honestly improves your chances of opening an account. Why? Surveys of prospects find the number one thing they want from you is 'honesty.'

Over the past several years, major Commodity Exchanges, Futures Commission Merchants, major FCMs have hired the Walsh Agency to conduct market surveys, to determine the reasons why futures prospects open accounts and why they don't. The number one reason prospects open accounts is because they trust the broker. On the other hand, the number one reason prospects do not open accounts is because trust is lacking. Disclosure of material information gives you a marvelous opportunity to establish trust. If your prospect believes you, he/she is more likely to buy from you. Here are some examples.

A prospect likes the action of the futures markets and plans to day-trade. He's made money paper trading. You must disclose the impact commissions have on a day-trader. You should also disclose the likelihood of occasional slippage – fills off the market. You must explain that his paper trading may not be an accurate reflection of how well he will do with actual trading for two reasons:

1. Paper trading lacks the "emotional" and "real money at risk" factors; and
2. The fills he gave himself paper trading may be misleading because the price on the screen will not necessarily be the price of his fill.

Another prospect has saved $10,000 to "take a shot" at the silver market. Tell this prospect, and all prospects, about the possibility of locked-limit moves and the possibility of losing more than $10,000.

Another prospect, who has never traded, has a "can't lose trading plan." It makes use of conservative spreads and stop loss orders. You must point out that spreads are not necessarily conservative and that one leg of the spread could conceivably move independently of the other – both against the trader. You must disclose that in certain situations, such as a high-volume very fast opening, the market can trade right by and be several ticks beyond his stop before it is filled.

Here is a partial checklist of disclosures you may want to consider, depending on the situation. It is not all-inclusive.

- Futures trading is not for everybody.
- Futures trading involves the risk of loss.
- Money invested in futures should be risk capital not necessary capital.
- Most individual futures speculators lose money.
- Most trades will probably be losing trades.
- Slippage (fills off the market).
- No fills (errors).
- Locked-limit markets.
- Spreads and/or straddles are not necessarily conservative.
- Options don't necessarily have limited risk.
- Options do not necessarily move in relationship to the underlying futures contract.
- Options are not as conservative as they may sound. You could lose everything you paid for the option.
- Margin calls.
- If margin calls are not met in a timely fashion, you can be taken out of the market.
- Futures trading uses leverage—explain this principle to your prospects.
- The investor can lose more than his initial capital.
- Markets can be thin and illiquid—explain this trading risk to your prospects.
- Markets can be violent and fast.
- Brokers, floor personnel and back office people can and do make mistakes.
- Futures trading can be an emotional, gut-wrenching experience.
- Commissions and fees can be substantial and have a negative impact on possible profits, if any, and/or magnify losses.
- You trade your own account (if you do). This disclosure is not required but recommended by many compliance people.

The more you disclose, the <u>less</u> trouble you are liable to have once the account starts trading. The less you disclose the <u>more</u> trouble you are liable to have once the account starts trading.

The disclosure of material information for Managed Futures including funds, is covered in more detail in the Managed Money section of this course.

One of the most successful futures brokers in our industry converted about 70% of her prospects into accounts. She only prospected using seminars. Here's the material information she disclosed. At the beginning of each seminar she said:

1. "I don't know what the futures markets are going to do. If I did, I would not be a futures broker. I'd be trading my own account from the deck of my yacht on Acapulco Bay. However, I believe we have a pretty good research department. With their help and good money management rules, I bring a professional approach to your trading."
2. "Most of my trades are losing trades, which is normal in the futures markets." She disclosed this because she wanted her clients to know that most trades would be losing trades. This way, clients would be less likely to try and wait for a losing trade to become a winner. Sound familiar? She was conditioning them to "cut their losses short".
3. "Most transactional, spec futures traders lose money and most of my clients lose money." She told them this because she did not want her clients to have unrealistic expectations. She told prospects all the bad that could possibly happen ahead of time. Then, she figured, if her prospects still opened, they would be less likely to be upset if they lost money.
4. "Most people who trade futures lose money."

This woman opens a higher percentage of her seminar attendees than any broker in her company of six hundred brokers.

A manager of a twenty-five broker IB in Atlanta, teaches his APs to tell experienced traders that commissions and fees can use as much as 25% of their trading capital per year and maybe more. He continues, tell them, "so we have to make 25% a year just to break even!" Most experienced traders know this anyway. All they have to do to confirm it is analyze their account statements. Surveys of more than two thousand transactional brokers indicate their commission-to-equity ratios range from 25% to 30% per year. Disclosing this information to experienced traders helps establish trust. This manager also teaches his staff to disclose commissions and fees to prospects who have never traded and to explain trading conservatively will lessen their effect.

If you sell managed futures, such as funds, you may want to disclose futures funds can be volatile. Significant draw-downs can occur and there is a possible penalty for early withdrawals. Disclosing material information ahead of time helps your clients avoid surprises. When it comes to their money, clients have told us they don't like surprises.

Here's how Steve Solomon, $35 million annual gross (much of it from managed money) and one of the brokers in our book ***Master Brokers***, discloses material information. He says, "I'm a more negative sell than a positive sell to prospects. I will talk about risk control and money management before I talk about possible profits. I make someone aware of how we hopefully will deal with risk before we talk about reward. Prospects should be made aware of all the negatives first. If you meet prospects who haven't had experience, even though they may be sincere and well-meaning, understand they haven't experienced some of the dilemmas that lie ahead and talk about them."
Here is an example of how prospects are hungering for an honest approach. A major FCM ran full-page ads in The Wall Street Journal. One of their ads was headlined, "Why Most Futures Traders Lose Money." Every time it ran, it generated at least 50% more leads than any of their other ads. Why? The headline disclosed material information that conveyed honesty and believability.

You must disclose to your prospects who want to open a trading account that any money invested in futures should be risk capital not necessary capital. This concept is at the center of this disclosure requirement. As we mentioned earlier, some brokers even tell prospects that most people who trade their own account lose money. The AP points out to the prospect, "If you open a speculative account and lose every cent, it should not make a difference in your lifestyle."

Many prospects know that most futures traders lose money, trading futures is risky, margin calls can happen, among other negatives. If you disclose these problems, you improve your chances of being perceived as an honest broker.
If your trading ideas are coming from a Commodity Trading Advisor, you must disclose this to your clients and also provide them with the required disclosure documents when appropriate. The principle of trust is very important here. If your clients hired you because of the trading skills they believe you possess, they may be going along with your trade recommendations because they have confidence in you. It may not be as easy to get them to put on positions if they know your trading ideas are coming from someone else.

Sales Practices

Sales Practices is an area that can either make you or break you as you sell futures to the investing public. Most futures salespeople we have interviewed and worked with are ethical, law-abiding, and professional. They identify and fill needs. They sell their futures products and services by asking questions, listening, and educating. They convey as much information as possible for the prospect to make up his or her mind. The true professionals in this business never try to talk futures prospects into something they really don't want to do.

Examine your book of clients. Did you pressure any into opening an account? If the answer is yes, have these been satisfactory relationships? Probably not. Most of the best brokers we have gotten to know over the last twenty years use very conservative sales practices. This section shows you how they sell legally and ethically to increase their business. We also cover what compliance people and regulators said about violations in this area, including ways to help keep yourself and your firm out of trouble.

One of the most common violations in the sales practice area is a broker overstating and/or misrepresenting his performance record. Some brokers seem to believe they need to make claims of 25%, 30%, or 40% annual returns to convince a prospect to open an account. More than twenty years' of marketing research finds that most prospects do not believe these claims made by transactional brokers. Prospects say that if the broker is doing that well, he would have all the clients he could handle and would not be prospecting. Calling the markets correctly and making big returns are not prerequisites for success.

One of the most successful brokers in our industry, Hartley Connett, a futures broker from New York City, who specializes in the energy markets says, "I would say that calling the market right everyday is one thing you don't have to be so concerned about. You do not have a crystal ball. You have a conviction, an idea; back it up fundamentally and technically. Okay, if it gets here and you're wrong, you're out. Clients will never have a problem with that. The problem is the brokers who are saying, 'You've got to buy it, you've got to buy it, it's going up.' There are many guys I've seen who have done that. They'll get that one good run, but the law of averages always catches up to them. Don't be a real aggressive 'gotta buy, gotta sell' man. Don't try to be the hero who's going to outguess the market. You've got to be flexible. Give them all the information you've got. 'Based on that information, it's my opinion that this is what might happen. On the other hand . . .' I mean, you have to hedge yourself a little bit. They want to know your opinion, but make sure it's based on good reasons."

Hartley continues, "Be humble, be careful about how you talk the market. Talk intelligently. Know what you're talking about. Do as much research, homework, talk to as many people as you can, get a feel for what's going on fundamentally. If you do recommend something, say, 'I feel it's going to do this because of these fundamental reasons and these technical reasons. If this happens and it gets over this level, I'm out.' Establish what your risk and reward parameters are. Be professional."

Ed Jernigan, from Nashville, Tennessee, a commercial futures broker with Morgan Stanley, specializing in cotton, tells prospects he doesn't know what the market is going to do, but he does say, "I want your business, and I'm prepared to earn it. I'll always be honest. I know what I'm talking about. I can't tell you if it's going to go up or down, but as far as the other information is concerned, I can give you the best available and I'm never going to sell you on a deal. The only reason I got some of the business was that when I went to these people over a period of time, they learned that I wasn't calling on them saying, 'Buy this because it's going to go to the moon.' Eventually, they learned that I was calling on them not to earn a commission, but to earn their hedge business. It worked over a period of time. Sometimes it takes years."

Here are some additional examples where performance claims could cause problems:

If you trade your own account and have a good track record, you may use this as a sales point. However, if your track record benefits from lower commissions you must explain this. If your track record is good because your trading ideas reflect a consensus of other brokers' expertise you must explain this. You must explain any extenuating circumstances about your trading if you are using it as a sales point.

You're not allowed to change firms and talk about your trading record with your new firm only. You must give equal balance and full disclosure to any claims you make. If it is necessary to give an accurate picture if you make claims, you must include the performance of your clients at your previous firm.

Remember, you must give equal balance to risk of loss when you talk about profit potential. Imagine yourself at an arbitration hearing with a disgruntled client. When the client tells the arbitration board how you were so enthusiastic about the possibility of big gains, are you going to be able to honestly say that you also warned your client about the possibility of large losses?

If you handle a self-directed account (the account calls all the shots), you must be careful about any claims. If you make claims about that account's performance, you must explain that you do not participate in any of the trading decisions.

The most frequent sales practice violation is downplaying risk and overstating profit potential. If you do this, you could be setting yourself and your firm up for a lawsuit. This behavior has gotten many brokers and their firms in trouble.

The National Futures Association has disciplined and/or barred from the industry more than one hundred firms for sales practice fraud – most all of whom were guilty of overstating profit potential and downplaying risk. The Commodity Futures Trading Commission has also been successfu in ridding our industry of many charlatans. These regulatory efforts must be working. Each year there are fewer complaints by the public about the sales of futures and futures options.

Claims about commissions are a potential pitfall when selling futures. For example, you must be careful not to gloss over and/or minimize the impact commissions and fees can have on a fund's performance. A regulator told us a broker got in trouble when he said, "Commissions in futures are pretty comparable to stocks except that with futures you only pay a commission when you close out a trade, and with stocks you pay a commission when you buy and when you sell." Brokers have been expelled from the industry for misrepresenting their commission structure along witl other violations.

Commissions can have a great impact on a transactional account. Talk about this with your prospects (experienced traders and novices) before they open an account. Again, you want to avoid surprises. You don't want a client, new to the futures markets, to call you someday and say, "I just figured it out, about 30% of my money goes to paying your commissions, no wonder you're always trying to get me to trade!"

Another sales practice violation the regulators are on the lookout for are "seasonal claims" by unscrupulous brokers. These claims often take the form of a representation such as, "heating oil prices have gone up in January, nine out of the last ten years." The regulators want to know if the claim is for January 1 to January 31, or if it is just an end of the month claim, or a middle of the month claim. Are those making the claim only using the days in each January that substantiate their claim? These claims are often misleading and occasionally downright fraudulent. If you are sc inclined to sell seasonal claims, be sure you compare "apples to apples." You must be able to prove these claims with facts.

Brokers often use seminars as sales tools. The sales practices used at seminars are subject to the same rules and regulations you must follow in all your solicitations.

All promotional material to solicit attendance at the seminar must be in compliance. The same rules for promotional literature discussed in Section One, "Communications with the Public," apply to your seminar promotions. For example, if a broker phones prospective attendees and says, "come to our seminar and learn how a ten cent move in the beans can make you $5,000," he must give equal balance to the risk of loss during that same phone call.
To avoid a potential violation, many brokers use a more educational approach when promoting seminars.

Any persons involved in sales solicitation at the seminar must be properly registered. Any sales scripts used at the seminar are also subject to the same rules and regulations as all other promotional literature. You are required to keep copies of these scripts on file in a readily accessible location for two years from the date of the last use and for a minimum of five years altogether. An audit and review of your script could easily determine if your presentation was in compliance. Again, if you talk about profit potential you must give equal balance to risk of loss.

One sales technique used at seminars is to show attendees the account statements of a client who is making money in the markets. The client's name is usually blocked out for confidentiality reasons. If you do this, you must also show how your other representative accounts are doing.

Another sales practice that can get you in trouble is disclosing the trading or trading intentions of others. Occasionally, a broker does this to get a customer to make a trade. The broker says to the client, "I just talked to the floor and (name of large candy maker) says inventory is at all time lows and they're going to be hitting the market with some size." Or, the broker may say, "Everybody in the office likes the bellies, in fact, the guy at the next desk has (name of large meat packer) as a client. They're going to be 'buyers' starting Monday."

It is illegal for you to tell your customers about the trading intentions or supposed intentions of anyone. You are not allowed to solicit or share any information about anyone's trading intentions, except with those people in your firm and others such as regulators who are entitled to know. Any information you use must be public information, not inside information.

Another practice that has gotten brokers in trouble is guaranteeing a customer against loss or assuring a customer his losses will be limited. Many prospective traders have heard of people losing substantial amounts of money, including more than their initial investment. They are afraid this could happen to them.

Unscrupulous brokers have said to prospects, "This is such a sure thing, I guarantee you won't lose." Of course, this guarantee is not only unethical, but also illegal. Many brokers who have made such guarantees have been barred from the industry for this in addition to other violations. However, a more common form of guarantee now appears to be when a broker assures a prospect that his losses will be limited to the amount invested.

There are no guarantees that any futures position can be liquidated in a timely fashion to avoid losing more than the initial amount invested. There are no guarantees against locked-limit markets where a client is locked-in a market, sometimes for days. It can and has happened.

In conclusion, here's what Roy Sheffield, a commercial broker with UBS in Portland, Oregon says about sales practices, (from his interview in ***Master Brokers***). "In my world, I don't think you can ever be successful without being completely honest with clients. If someone confides in you that confidence always has to be respected. At the end of the day you'll be rewarded for it. Now, we do business with ten or twelve people who compete with each other many times. If they were all in a room together, would you say the same thing to one as you would the other? You must be able to look yourself in the eye before you're able to look someone else straight in the eye. Your prospects and clients will respect your honesty and they will confide in you more if they feel that you have the integrity that warrants confidence."

"If you want to have a relationship for a long time, you work with prospects and clients. Identify their needs, and maybe their needs at the time don't include trading, and therefore, no income for you right then. If you want to make x amount of dollars over the short term, so be it. In our industry, when people call up and sell special situations, I think it's very much like being a used car salesman. 'Here, this is perfect for you. Buy it today, before someone else does.' Often brokers have too many short-term objectives. 'Well let's see, I can call this guy and open the account, get x number of commissions out of him, and then I'll go get somebody else.' You develop distrust, not only with yourself, but with the people whom you're soliciting when you're only trying to gain something short term. The clientele I have, I've traded with them for ten, fifteen years plus and hopefully I'll have a relationship with them for the next fifteen years. Approach it as, 'I'm going to open this account and I'm going to have this account for x number of years, and we may not even trade that much.' You can't be short term."

Acting honestly and fairly with due skill, care and diligence in the best interest of customers and the integrity of the market (I)

This section deals primarily with your daily activities and responsibilities towards your customers. These include your treatment of customer orders and handling of customer business.

You are required to put your customers' interests ahead of your own. The principle here is, "your customers come first." This starts with something as basic as being available to your customers when necessary. Too many times, customers have been known to complain, "I couldn't reach my broker," "He never called me back," "I needed some information," "I wanted to get a price," "I was going to place an order," or "I wanted to get out of that position but couldn't reach my broker." You are required to be available to your customers. It's just that simple; it's part of your job. Some of the most irate customers, who are prone to sue, are customers who are ignored, particularly if they have a complaint. In fact, if you receive a written complaint, you are required to notify your manager immediately. If you are a one-person office, notify your home office compliance people immediately.

Small complaints that are not dealt with can become large problems. As one compliance officer said, "An unanswered complaint can turn a $500 problem into a $5,000 problem." Newer brokers who are taking this course should be particularly wary. Occasionally, a new broker will try to handle a written complaint on his own. He doesn't want his manager to find out, so he will call the customer and try to settle things. Keep in mind, you are required to notify your manager. You call your customer, he seems to cool down and you think the problem has gone away. A few weeks later the same customer is upset again and writes directly to your manager. In his list of complaints, he mentions the problem you previously hid from your manager. Don't try and "cover things up," they will catch up with you eventually.

If you are more experienced, such as an equity broker selling funds, you already know the importance of taking written complaints to your manager immediately. For example, if you write a complaint letter about a product or service and it's handled quickly and courteously, aren't you less likely to take it further? However, if your letter is ignored, or the salesman calls and tries to minimize it, aren't you more likely to take it to a higher authority? Nobody likes letters to the regulators. Your compliance department and the regulators are adamant about complaints being handled quickly and fairly. For example, the National Futures Association's Self-Examination Checklist has a section entitled "Supervision," which lists twenty-two areas of responsibility. More than twenty-five percent of these areas have to do with or involve the treatment of customer complaints.

The proper treatment and handling of customer complaints is a serious matter, so take it seriously.

One of your most important responsibilities is the proper handling of customer orders. Violations in this area have resulted in brokers being barred from the industry for life, not to mention large fines.

When you receive an order, get it to the floor right away. Occasionally, a broker holds an order and waits for the market to "come to him" or move just a bit in hopes of getting a more favorable price. The minute you receive an order from a customer, you are required to immediately time stamp it, record the customer's number and all other required information. You are required to get it to the floor immediately. You are not permitted to wait for the market to come to you – no matter how sure you are that you're going to get a more favorable fill "in just a few minutes." If you wait a few minutes and the market starts moving away from you, you're in trouble because you did not enter the order as soon as you received it. "Holding an order" is easy to verify with telephone records, time stamping on the order ticket and time and sales records on the exchange floor.

Another area that can get you in trouble fast is not putting a customer's number on the order ticket as soon as you get the order. Brokers who have allocated trades based on fills and put customer numbers on tickets after the fact, have been expelled from the industry. Your supervisor is expected to watch for this violation with as much diligence as possible.

It seems to be a trait of many brokers to want to give customers only good news. Regardless of the situation, some brokers seem to put a positive spin on just about anything happening in the customer's account. Distorting a customer's account can get you in trouble. Often at arbitration hearings, customers will comment, "I didn't realize I was doing that badly. In fact, I distinctly remember my broker saying, 'We took some profits today'."

For example, a broker closed out a customer's winning position and made $500 on the trade. However, the open positions showed a $900 loss that day. The broker is not allowed to say to the customer, "Took some profits today, made $500," and leave it at that. The broker must disclose the $900 loss and report to the customer the condition of his account "marked to the market," which would include the value of his open positions as well.

Another area that gets new and experienced brokers in trouble from time-to-time is margin calls. You should thoroughly discuss the concept and the possibility of margin calls with your clients before they open the account. If you avoid this responsibility, you are not only asking for trouble, you are volunteering for trouble.

This is an area some brokers are afraid to bring up in the prospecting process. It speaks directly to the fear that most prospects have about losing more money than their initial investment. That is why some brokers gloss over it. Some brokers actually tell their customers to ignore a margin call because "the market will come back tomorrow".

Discuss, disclose, dissect, dwell on, elaborate, announce, explain, and teach the distinct possibility and probability of margin calls ahead of time. Explain that margin calls are due when generated.

Downplaying the possibility of margin calls and not making margin calls are two reasons futures brokers have changed careers, and not always by their choice.

Clients have sued brokers and their firms for not making margin calls. The client's position was, "if they had insisted on the margin money, I would have liquidated my positions that first day and would not have lost all that money staying in the market for a few more days." If you let a client accumulate margin calls, a common complaint is, "you should have liquidated me sooner." The client then claims the firm is responsible for subsequent losses because the firm failed to follow its own policies of liquidation if margin calls aren't met.

Another example of not wanting to be the bearer of bad news is the habit some brokers have of "rounding up" or "rounding down," when giving quotes. This unethical practice goes like this. The customer calls in for the price of November soybeans. The customer is long. The price is $6.49 a bushel. The broker, wanting the customer to feel good, says, "about $6.50." After all, he reasons, it was $6.50 just a minute ago. A few minutes later another client, who happens to be short beans, calls in for the price of November beans, which are now trading at $6.46½. "About $6.45," says the broker. After all, they did hit $6.45 earlier in the day, he reasons. Do not do this, even if you hear the broker at the next desk doing it.

Many brokers have encountered problems over the years by not taking orders the proper way. When you are taking an order be sure to repeat your customer's order aloud and have your customer confirm the order verbally. Some customers are somewhat inexact when placing orders. It's up to you to put the order in the proper words including naming the contract, the year, the month, the number of contracts, the type of order – buy or sell, price limits (if any) and time limits if appropriate. You must not leave anything out or subject to misinterpretation. After you have stated what your customer said he wanted to do, you must have your customer confirm verbally that this is the order he wants you to place.

Discretionary accounts are another matter. If you are a transactional futures broker, you must have at least two years' experience before you are allowed to accept discretionary accounts – unless you are granted a waiver by the NFA. **Written procedures** must be adopted and enforced for the review of discretionary trades. These procedures must ensure that someone in a supervisory or managerial capacity (other than the registrant who exercises discretion trading the account) reviews discretionary trading activity. It is also required the supervisor or manager conducting the review make a written record of the results of that review and that such review took place.

Occasionally, trading limits are placed on an account when trading begins (or at other times). It's your responsibility to make sure these trading limits are honored, no matter how much the account has grown or lost. Also, if you inherit an existing account, part of your review of the customer's file is to determine if any trading limits have been placed on the account.
Another test of your due skill and care is how to handle a client who starts entering wild and irresponsible orders. If this happens, you must not sit idly by and simply accept these orders. Consult your manager – you should attempt to protect the client from himself. These are extremely vulnerable situations for you and your company. You know when trading habits and patterns change. A conservative client becomes reckless, small losses are becoming big losses, a client becomes particularly stubborn and not only keeps hanging on to losers but may even add to them. You know the signs. If there is any doubt or concern don't make it your problem alone, share it. Don't wait and give it one more day, or even one more minute, don't walk but run to your manager.

Acting honestly and fairly with due skill, care and diligence in the best interest of customers and the integrity of the market (II)

This section addresses the same type of responsibilities covered in the previous section. The title of these two sections goes right to the heart of what the ethics training requirement advocates. That is why we focus so much of our attention on this material. If you are acting honestly and fairly, you are living up to your responsibilities to your customers, the markets, your company, the public and yourself.

This section also covers your daily activities of handling customer orders and customer business. We are going to continue to focus on what we learned from our survey of compliance officers and regulators. The examples cited here are also what they look for to make sure you are in compliance.

Let's look at one of the most sensitive areas in our business, churning. One definition of churning is: trading for commissions rather than in the best interest of your customers.

Here are just a few of the areas that come under surveillance.

Commission-to-equity ratio. How much of your clients' capital is used for commissions? Compliance people and regulators do not specify a precise figure. Each situation must be examined on a case-by-case basis. They look to see if your commissions go up when your equity goes down. When some brokers lose equity, they tend to trade a little more aggressively. This is something that can draw attention to yourself. Trading for commissions is not acting in the best interests of your customers. Can your trading withstand this scrutiny?

Reversal trading systems. This is a trading technique where the customer is always in the market – long or short, depending on price movement. Of course, whenever a position is reversed, a commission is generated. A reversal trading system is not necessarily bad in and of itself. The question is, "what is your motivation, profits or commissions?" Reversal systems are particularly vulnerable to investigation and are extremely susceptible to a charge of churning.

Very close stops. Some brokers put the stops so close to, or in, a trading range that they are almost surely to be stopped out. This may lead to more trading, which leads to more commissions. The people we surveyed do not have a problem with a broker using stops. In fact, many of them sai stops may be an integral part of a sound trading plan. Their concern about stops is that they can be placed suspiciously close to the market.

Spreading a losing position. This is not necessarily wrong, but you may draw attention to yourself. Was the losing position spread for a solid trading reason or was it spread to generate another commission? Spreading a losing position generally locks in a loss on one leg of the spread. If you use this technique, can you defend it with facts to your compliance department and/or to the regulators?

The heading for this section contains the words, "due skill, care and diligence." It is your responsibility to provide expertise. Many clients depend almost blindly or naively on their brokers. This trust and confidence must not be taken lightly.

If a client is losing big in a position and just "wants to get out," occasionally a broker tries to "work the order" and may not get filled as the market runs away from his client. This is wrong. When somebody wants out, get them out or be prepared to defend yourself as to why you didn't.

Front-running is a serious violation of the rules and regulations. For example, brokers have placed orders for their own accounts, or favored customers' accounts, ahead of a large commercial trader's order in an attempt to gain a price advantage. You are not allowed to place orders for your own account ahead of your customers' orders – ever! You are not allowed to place any customer's order in front of another customer – ever!

Have you heard of "Desk Drawer Power of Attorney?" It is a POA a client has signed and given to the broker, to grant discretion to the broker over the client's account. However, the broker keeps the POA a secret. This way, the broker can trade the client's account with discretion without indicating that it is a discretionary account. This means the account is not subject to the additional rules, reviews and close examination required of a discretionary account. This is illegal!

The major reason a client switches from one brokerage firm to another is lack of attention by the broker. Whether your clients are actively trading futures or have managed futures accounts, such as funds, you are expected to pay attention to them. You are expected to advise them on the status of their account. With a fund, daily updating may not be necessary. Funds are generally considered longer term investments than transactional accounts. However, the broker must stay current with what's going on with the fund. If a fund experiences a significant change, the broker should advise his client accordingly – preferably before the client hears about it from another source. It is important to tell your clients in advance about any significant loss, rather than have them discover it in their statements.

A transactional futures broker has many more responsibilities when servicing his trading accounts. One of the most important times for a broker to be in constant contact with a client is when major losses are occurring. Possibly, the most important time for intense contact is when margin money is due and owing. This is the time when some brokers avoid client contact. The broker must be available for margin calls, advice, information, accepting orders and sometimes to just listen.

Brokers have been known to give very large accounts a break. For example, this has happened when an important client got a fill way off the market against him. The broker promised to make up for this "slippage" on a later fill. How did the broker do that? He gave a discretionary account's good fill to his big account and stuck the discretionary account with a fill off the market. This is illegal.

While the example cited a fill that was way off the market, you may want to explain to your customers that the price on the screen is not necessarily always the price on the floor. Customers should be told of this in advance. It may save you a lot of explaining particularly when novices start trading.

Unauthorized trading is still one of the most common violations in our industry, and one of the most serious. Unauthorized trading comes in many forms. A seemingly harmless way is placing an order for a non-discretionary account of a close friend. He is out of the country and you just know he would want to put on this trade. You reason, by the time you reach him, this "great opportunity" will be gone. This is illegal. If the regulators decided to check telephone records, you could be caught!

Another form of unauthorized trading is trying to trade your way out of trouble. You have talked someone into a trade that is not working out. Rather than admitting your mistake to your customer, you compound it by putting on additional unauthorized trades to try to make up for the loss. An almost sure way to have the market go against you is to put on an unauthorized trade. Ask an experienced broker about this.

Another part of your "due skill, care and diligence" responsibility is your on-going education. You must keep up with the industry, the contracts you are trading, any changes or new rules and regulations, changes in contract specs, types of orders permitted at various Exchanges, new contracts, company policies – literally dozens and dozens of aspects of the industry as they relate to you maintaining your ability to act intelligently in the "best interest of customers and the market".

The last part of the heading for this section reads, "…in the Best Interest of Customers and the Market." The markets are the Exchanges. The Exchanges are often erroneously blamed for some of the problems that can occur. It appears to be common practice in the futures business to hear a broker say about the floor: "oh, they're running our stops and taking us out" or "they're driving out the shorts" or "they're pushing things to the moon." How many times have you heard it said in this business, among ourselves, as well as by clients, "oh, those guys on the floor, they ripped us off again?" Floor traders/floor brokers are often convenient scapegoats for what's happening in a market at any given moment. Think about what statements like these do to the public's perception of our marketplace? They make it sound as if the markets are rigged and that prices can be manipulated. For example, the insinuations about "running stops" pre-supposes floor brokers have disclosed their decks, or at the very least, told others where their stops are! Statements like these are not in the best interest of the markets, or in your best interest. Please explain electronic 'black box' trading to your clients.

Another area where the integrity of the market is challenged is when a retail broker telephones a broker on the floor and asks him "the color of the market." This is an illegal way of asking a floor broker if his deck is bullish or bearish. It is also an illegal way of asking for information about size – are there any large orders looming? Some traders call them "icebergs." You are not permitted to solicit, attempt to solicit or ever disclose any inside information. This activity is unethical as well as illegal.

We intentionally spent two sections on this material because of its importance. While we covered many examples and cited many violations it would be impossible to list them all. If you act honestly and fairly, you will be doing what is required of you.

Conflicts of Interest and Confidentiality

Do you know of any career that has more potential conflicts of interest than yours? Conflicts of interest seem to be everywhere when selling futures.

The first conflict of interest may be in selecting whom you prospect. If you're a securities broker, do you automatically prospect everyone in your book? Are all your existing accounts legitimate prospects for a fund? Or for individually managed futures accounts? Will they be comfortable with the possible swings in value, even though you alert them ahead of time? If their portfolios are small, should they be in managed futures at all? Even a fund?

Let us assume you have decided to offer managed futures to clients for whom they're appropriate. What do you sell them? There are more possible conflicts here. Does one product offer a bigger up-front payout? Or a bigger trail? What about performance? How do you resolve these conflicts? While each decision may seem difficult, the answer is always easy. You must put your clients' interests ahead of yours. This is the key principle of this course: clients come first!

Selling trades is a conflict you face every day. You are a commission salesperson. You don't make any money unless your clients trade. Do you put on a position because it's an excellent opportunity or is a commission the primary motivating factor? Do you talk yourself and your customers into trades? Why? Why not? Analyze your commission-to- equity ratio. When your total equity on the books goes down, do you trade the remaining equity more aggressively to make up for lost commissions? Are your trades based on a sound trading plan with reasonable risk/reward ratios rather than a need for income?

Compliance departments look at brokers' commission-to-equity ratio on a regular basis. The reality is that you are a commission salesperson. The potential conflicts of interest will always be there. They're part of our business. It's up to you to handle them honestly and fairly.

Another major potential conflict of interest occurs if the broker trades his own account. You are required to put your clients' interests ahead of yours. If you're trading your own account and your clients' accounts whose positions do you shepherd best? What happens if your personal account starts losing a lot of money? Or making a lot of money? Is there a conflict between choosing to "baby-sit" your positions or your clients'? We're told some brokers handle these potential conflicts very well and some do not.

The late Marshall Persky, a three million dollar futures broker from Chicago, said (from his interview in ***Master Brokers***), "not trading my own account is the biggest boon that happened for my business. I tell people what I truly feel, and they know there is never any conflict of interest because I'm not spending time and energy trading my own account. I inform people very early in our relationship not to choose me as their broker to do their trading for them."
"If I were a successful trader, would I continue to take on the burdens of a broker? Clients select me as someone who can service and handle their accounts, who can execute well, and who knows, or knows where to find, answers to questions they may have."

In the futures industry, your past employment history follows you. If you apply for a job at another brokerage firm, your prospective employer is required to contact the National Futures Association as part of their background check.
If there are any complaints, violations, disciplinary actions or other problems filed against you in the futures industry, your prospective employer will find out. If you get in trouble with one firm, you cannot simply walk out the door of your old firm and walk into a new one and start selling futures again with a clean record.

Another conflict can occur between you and your company. Futures brokers have been known to "go to bat" for a big client at the expense of their company. The broker may convince the company to "eat an error" for which the large customer is really responsible. The broker may convince the company to provide extra services to a large client – services to which he may not be entitled. This conflict of you fighting for the client can go too far. For example, it can happen when your margin department calls. The broker finds himself between the client and his margin department and sides with the client. Brokers have actually tried to undercut their company's efforts to get a client to meet a margin call.

A conflict of interest with a vendor. A software vendor recommended a brokerage firm and the firm recommended the software to their clients. Was it the best software for their clients? Did the brokerage firm disclose the arrangement?

A branch manager has a potential conflict of interest in the way he treats a big producer. It's fine for the manager to give a good broker ethical and legal perks. However, a major problem exists if the manager "looks the other way" if a broker bends or breaks the rules. This can take the form of questionable practices concerning the broker's own trading account, enforcement of margin calls, discretionary trading, over-trading, irresponsible and reckless trading, allocation of trades, complaints, errors, etc.. The conflict exists when the manager receives a percentage of his brokers' production. This "special treatment" of big producers can lead to serious violations, fines and possibly loss of employment for both.

A conflict of interest can occur when a broker has to weigh the amount of time and effort put into prospecting versus servicing existing accounts. This client service versus prospecting conflict is a particular problem in the "high-pressure sales" part of our industry. To quote from NFA's Regulatory Guide for Futures Commission Merchants and Introducing Brokers: "Suspicion of a high-pressure approach is frequently confirmed in the servicing of an account after the initial deposit is made. Whereas, prior to opening the account the customer heard from the AP almost daily and the market was making critical moves with surprising regularity, after a deposit has been made the customer often cannot reach the AP and is uninformed as to the status of the markets."

The last part of this section deals with confidentiality. Keeping confidential information confidential is another of your many ethical and legal responsibilities.

Disclosing someone's trading intentions is a serious violation of the principle of confidentiality. Often, pressure is put on upstairs brokers, as well as floor brokers, to even "give a hint" about a customer's trading intentions. You are prohibited from disclosing and/or attempting to learn this information. This is true for one-lot orders as well as thousand-lot orders.

Another problem, which occurs in this area, is a broker implying that he has inside information. The violation usually happens when a broker is trying to get a client to put on or take off a position or even open an account. The broker might say something to his customer such as, "well, as you know, I'm in constant contact with the floor and all I can say is… (then the broker pauses dramatically) well, I am not really allowed to say. I don't know for sure if this is going to happen, but if it does, there is going to be a dramatic move. We have to act quickly because he (the anonymous, mysterious 'he') didn't say when it was going to happen." The broker continues (to cover himself), "and, of course, there are no guarantees it's going to happen but if it does there's going to be some serious money made." Brokers, with just their tone of voice, can clearly convey the impression that they have learned some confidential information. This is unethical and illegal.

The principle of confidentiality is often broken in the broker's office. For example, large clients' trading intentions have been announced to the room by a bragging broker. You're not permitted to do this. The location of your clients' stops is also confidential information. You're not permitted to disclose stops to other brokers, clients, anyone other than those required or entitled to know.

A primary purpose of ethics training as spelled out by the regulators is, "…to ensure you understand your responsibilities to the public under the Act." The concept of maintaining confidences plays a major role. The public is entitled to trade our markets without being at the disadvantage of you disclosing confidential information to other market participants.

If you use confidential information, you are inviting trouble. Often, there is a traceable pattern of which the broker may not be aware. For example, whenever you put on more trades than normal in your account or your "special" customers' accounts, you could be sending signals without knowing it. Be aware, this is a trading pattern that is easy to identify. Your compliance department and/or regulators could check to see if a large order hit the pit shortly after you placed larger than normal orders for the same contract. Did someone share some confidential information in this situation? This kind of trading is also fairly easy to track. If someone does track it, will the trail lead to you?

Managed Money: Including Responsibilities of Commodity Pool Operators and Commodity Trading Advisors

The Commodity Futures Trading Commission publishes a report called a Proceedings Bulletin. It lists more than 10,000 violations and alleged violations of the Commission's rules and regulations. More than 7,000 of these listings apply to their regulations (as opposed to their rules).

Section 4.21, Disclosure to prospective pool participants ranks fourth, right behind options, supervision, and non-competitive trading on the list of regulations violated (and allegedly violated) most often. This fact is strong evidence that you must take your responsibility of proper disclosure to pool participants seriously!

Here are some of the disclosures that apply to pool participants. This list is not complete nor does it necessarily contain the disclosures your compliance department requires you to make. We only include this list to give you a sense of the tone, breadth, importance and critical nature of disclosure requirements to pool participants. Check with your manager and/or compliance department for the disclosures to pool participants required by your company.

1. Deliver the commodity pool document.
2. Explain the risk of the investment only from the document.
3. Do not use sales literature to explain the investment.
4. Be certain you are registered to sell the pool interests in the state where the customer resides, before you make the first telephone call.
5. Obtain sufficient information from the client to justify suitability to trade commodities.
6. Know the percentage of invested capital which may be made in a commodity pool where the client resides and limit the amount deposited to the pool, after consideration of any other pool investments, to no more than that percentage.
7. Tell the customer what account statements will be sent. If possible, send them a sample of the statement before they invest and go over it to be certain they understand the format and what to expect.
8. Explain that in certain circumstances, distributions may have to be returned in the event of loss, but that the personal loss is limited to the amount of the investment and those certain distributions.
9. Ask the investors if they read the offering document. Be certain they understand that the subscription documents include the affirmative representation by the client that they read and understood the document. Then ask them if they have any questions you have not covered.
10. Follow-up with regular telephone contact to be certain they understand the reports they have received.

In addition to the disclosures just mentioned, many compliance officers said the following should also be pointed out, specifically to pool prospects.

1. Commodity futures trading is not for everybody.
2. Commodity futures trading is speculative and volatile.
3. The investor could lose a significant portion or all of his investment.
4. A thorough explanation of a twelve month break-even analysis.
5. Any redemption rules, limitations, and penalties.
6. The investor's potential tax liability.

Individually managed accounts have their own set of rules and regulations. Here is a partial list. This list is an example only and should not be used. Use your company's list.

1. Deliver the Commodity Trading Advisor's disclosure document.
2. Deliver the Futures Commission Merchant's new account forms.
3. Discuss trading history in detail only from the disclosure document.
4. Discuss risks of trading from the disclosure document.
5. Explain that commodity trading is not for everyone and they could lose more than the total amount invested.
6. Explain the possibility of sudden and extreme changes in value.
7. Explain that past trading results are not necessarily indicative of future trading results.
8. Obtain sufficient information from the client to justify suitability to trade commodities.
9. Be certain that the client understands the amount deposited in the managed account is to secure the trades made by the CTA pursuant to the Power of Attorney directly to the FCM without involvement of the customer and the loss in the account could exceed the amount on deposit.

These rules and regulations are included here to demonstrate the form managed account disclosures take. Do not use this list for your required disclosures. Use your company's list.

Here's what Michael Pacult, a top broker from Fremont, Indiana, who is featured in ***Master Brokers***, says about disclosure to managed futures prospects.

"Brokers get into trouble for two reasons: fear of rejection and fear of telling the client bad news."

"Fear of rejection is simple to deal with by maintaining the proper mental perspective. Unless it's your mother saying, 'Don't ever call me again!,' why take it personally when a prospect lacks interest in your investment proposal? He could just be too busy, have no money, have a personal crisis, just been served divorce papers, lost his dog, etc.. Move on to the next call without putting down the telephone."

“Fear of communicating bad news is equally easy to deal with: always tell the truth, the whole truth and nothing but the truth from the very first conversation when the process of educating the prospect about the investment begins.”

“When suggesting managed futures as a non-correlating, diversifying addition to a balanced portfolio, an analysis of the trader’s past performance, especially the negative periods, can prepare the prospect, and hopefully future clients, for the inevitable bad news once trading commences. No trader has a crystal ball and even the best traders can have prolonged periods of sideways to negative results, so why hide that fact? Spend more time discussing the worst draw-downs and their duration than positive results.”

“Traders need time to perform, and a prospect without the temperament to withstand repeated losses and volatility is a prospect that you do not want as a client. However, if the client understands beforehand that even the most successful traders may be right only two trades out of ten, there will be no reason for the broker to fear picking up the phone to discuss the majority of trades that are not profitable, because the client has already been educated to expect such results.”

“The broker has an obligation to assist a prospect in determining if the prospect has the proper temperament to trade futures. A thorough discussion of the risks of trading, the volatility, the leverage, the potential market illiquidity, the loss of the entire investment and possibly more (in the case of individually managed accounts) need to be covered. The fee structure needs to be explained in detail and should include selling commissions, management and incentive fees, trading commissions, and redemption, legal and accounting fees, if any. The more detailed the discussion with plenty of opportunity for the prospect to ask questions will yield a stronger, more trusting and respectful client-broker relationship.”

“Needless to say, whether an individually managed account or fund or pool is being offered, all conversations must repeatedly be made with the managed futures broker’s holy trinity of caveats: this investment is only suitable for a limited amount of the risk portion of an investor’s total portfolio, no one should invest more than they can afford to lose and past performance is not necessarily indicative of future results. By listening carefully to what your prospect is saying during these discussions, hopefully the foundation for a long lasting relationship will be established with a client who has the capital and temperament to trade and with whom the broker looks forward to speaking, whether with good news or bad.”

It’s your responsibility to be knowledgeable and to continue to educate yourself about the products you sell. Our market surveys indicate that prospects reject brokers who don’t know their products. These surveys have found that some prospects feel brokers don’t know enough about managed futures, the fund(s) they are selling, the CTAs they are promoting and the disclosure document(s).

When you are talking with prospects about returns you need to know (and this is a quote taken directly from the NFA’s Regulatory Guide for Commodity Pool Operators and Commodity Trading Advisors), “Words such as ‘average’ or ‘compound,’ when used in connection with rates of return, may require additional disclosure. Presenting an ‘average’ return for a number of periods when the individual returns for the periods have fluctuated widely may be considered misleading without clarification.”

Commodity Trading Advisors may not trade ahead or “front-run” their clients for any reason. This is a serious violation of industry rules and regulations. There is no situation where a CTA is permitted to trade ahead of his clients.

Here are some additional potential problem areas for CPOs and CTAs.

New CTAs not telling everything to their attorney. Some new CTAs, in an effort to save attorney time (and therefore money), do not always disclose slight indiscretions of the past. Inevitably these “small problems” surface during the due diligence phase and can sometimes compound problems. The regulators advise, ‘disclose all, up-front’. It does not reflect well on the CPO or CTA if the regulators uncover anything that was being hidden.

Failure to conduct due diligence. Some CPOs and CTAs have actually tried to skip this part of the process.

Copying another CTA’s disclosure document. The CTA simply changed names, addresses, telephone numbers and performance data and tried to represent someone else’s disclosure document as his own.

Lack of documentation. CTAs include performance data for which they have little or no proof. They did not have an audited track record or any other proof of any other claims.

Misrepresenting performance. These have been cases of attempted deception—a serious violation.

Failure to disclose silent partner(s). As in all violations, ignorance of the law is no excuse.

Improper order allocation. This is a most serious violation, for which there is zero tolerance.

Deviation from Disclosure Document. If a CTA plans to trade differently from his representations in his document, he must first notify the pool participants of his intentions and obtain their permission.

Not checking unusual names to make sure they are legal, registered pools. If a CTA sees an unusual name in his list of customers, it’s his/her responsibility to check and make sure it is not an illegal, unregistered pool.

A disclosure document must include a break-even analysis to make sure the customer is not only aware of all the fees and expenses of the offering but also the impact they can have on the investment.

This analysis allows the investor to determine the total profits he needs to break-even upon redemption after one year. The analysis should include, selling price per unit, management fee, brokerage fee (minus interest income), redemption fee and total trading income for the investor to recoup his investment after one year (expressed as a percentage of the initial selling price).

CPOs and CTAs have many additional responsibilities regarding their disclosure document(s). Several of these obligations are listed in the NFA’s checklist which CPOs and CTAs must complete once a year.

State Suitability Requirements

The information herein is for illustrative purposes only. Check with your compliance department for State Suitability Requirements.

Various states have minimum financial suitability requirements for their residents.

Most states currently have the following financial suitability requirements to be able to purchase partnership interest in a commodity pool. The purchaser must have:

1. A minimum net worth of at least $150,000 (exclusive of home, furnishings, and automobiles), or
2. An annual gross income of at least $45,000 and a net worth (similarly calculated) of at least $45,000.

Many states have higher minimums. Find out from your compliance department (or in the disclosure document) these states and their minimums.

In addition, many states, as well as many CPOs and CTAs, limit the amount a person may invest in the partnership to 10% of their liquid net worth.

Some disclosure documents include the following statement after a listing of suitability minimums:

“These suitability standards are regulatory minimums only.”

“Just because the prospective investor meets the minimum does not necessarily mean that a high risk, volatile, speculative, illiquid investment is suitable for said prospect.”

Supervision and Internal Controls

Supervising is one of the most demanding jobs in the brokerage industry. Your manager is responsible for you, all the other brokers you work with, and virtually everything that happens in the office.

In the NFA’s Reports of Quarterly Actions, in cases where the broker has been found guilty, “failure to supervise” is almost always listed as one of the violations.

Therefore, as you begin to sell futures, your manager will be paying careful attention to you, not only to make sure you understand your company’s policies and procedures, but also to be certain you comply with the rules and regulations.

The Commodity Futures Trading Commission publishes a Proceedings Bulletin which lists more than 7,000 violations and alleged violations of their regulations. Regulation 166.3 Supervision ranks second.

Your supervisor is required to oversee your prospecting methods and your “communications with the public.” He is expected to check your outgoing mail to make sure you are in compliance. Remember, all prospecting letters must first be reviewed and approved in writing, before you send them. They must give equal balance to risk of loss and profit potential. Your supervisor is also expected to screen your incoming mail for complaints or any other possible problems.

Your supervisor must also review and approve, in writing, all communications such as, seminar materials, direct mail letters, pamphlets, twitter, flyers, advertising, publicity releases, any articles you may write, email, literally everything you communicate to the public. Your supervisor is also required to review your clients’ account opening forms. He must make sure all required documents are included and completed, including the Risk Disclosure Statement.

He checks for income and liquid net worth, as well as other factors regarding financial situation and investment experience. He also reviews the information to see if additional disclosure was required and if it was provided. Your manager may need to contact your new accounts to make sure you provided the additional disclosure if it was necessary. If it is, you and your manager should document that the additional risk disclosure was provided to and understood by the client.

To give you an idea of how extensive a supervisor’s job is, here are just a few more of his responsibilities, as listed in the NFA’s Self-Examination Checklist.

- “Provide adequate risk disclosure to customers purchasing deep out-of-the-money options.”
- “Require corporate resolutions authorizing trading authority and account (strategy) limitations signed by the appropriate level of authority at the corporation.”
- “Require Power of Attorney to be terminated in writing.”
- “If fees and charges are not determined on a per trade or round-turn basis, provide customers with a written explanation of the charges and reasonable examples on a per trade or round-turn basis.”
- “Maintain any documents produced or obtained as a result of the order flow/trading process for a period of five years, (i.e., customer order tickets, trade listing, equity run, customer statements, open position listing, day trade listing, P&S recap).”
- Silent telephone monitoring is another of your manager’s many responsibilities. He’s checking to make sure you are complying with the law. Many supervisors monitor their brokers’ telephone conversations.

It is critical for you to put all the proper information on every order ticket. You must be able to account for all tickets. When your supervisor checks your order tickets, he examines the sequence of numbers to make sure they are all there. You must keep and be able to account for all tickets – spoiled tickets, unfilled orders, canceled orders, errors. No excuses!

You must have written procedures for allocation of fills of block orders. These written procedures must be fair to all customers all the time. You must also have written procedures for the allocation of split fills.

Your supervisor is required to check profitable accounts for possible preferential treatment. Can your personal account withstand careful analysis? What about profitable accounts of your customers? When did you place your orders relative to placing orders for profitable accounts? When did you get your good fills? When did you get your fills “off the market”? At what price? Do you trade your account like your customers’ accounts? Do you trade your account like your non-discretionary accounts or like your discretionary accounts? Who gets what fills? To whom were they allocated? Is there a pattern?

Your supervisor has an additional set of responsibilities when it comes to options accounts. Your clients must sign additional risk disclosure document(s) (or the combined form) before they are permitted to trade options. Then your supervisor must approve every options account in writing.

On your options order ticket you must include the routine information as well as whether the order is for a put or call, strike price and the premium.

Supervisors are expected to be alert to brokers receiving customer money in their own name, brokers paying margin calls for their customers with the broker’s money, and brokers operating out of “summer homes” without the authorities being notified of this temporary branch office. Supervisors are not allowed to permit this without establishing it as a branch office and notifying all parties.

Supervisors are also expected to be aware of, and act on, what their brokers may not be doing, such as: not giving enough service to their clients, keeping them informed about what’s happening with their accounts, not advising clients of a change in commissions or fees, not staying within trading limits that may have been imposed when the account was opened, not calling for margin, not returning phone calls, not being attentive to paperwork, checking their equity runs before the market opens and reviewing all their accounts’ open positions and checking stops.

Use your supervisor’s knowledge and experience. He has seen dozens of brokers build their businesses throughout his career. Benefit from his/her experience and guidance. That is what he/she is there for. Maybe you are wrestling with a problem he helped another broker solve years ago.

Summary and Review

In our survey of compliance officers and regulators, we asked them, “What are the pitfalls for brokers who are new to selling futures?” Here is a synopsis of their answers. It’s a quick review of the material you’ve covered so far – but from a pitfall point of view. Almost everybody said to tell new brokers that, “futures trading is not for everyone”. Everyone is not a prospect.

First, look at what they said about funds. Not everybody in your book is necessarily right for a fund – even if they have the money. Do they have the temperament? Many stock accounts are very conservative and don’t handle draw-downs very well. You must say to a prospect, “How would you feel if the fund lost 25% of its value?” You must spend time conditioning prospects to the possibility of substantial losses ahead of time. You must attempt to condition your prospects to look at a futures fund as a long-term investment. Otherwise, many will want to (and do) liquidate on the first dip. Spend a lot of time explaining the break-even analysis with your prospects. Some brokers, new to selling funds, have downplayed this, fearing it would drive prospects away. Prospects are going to eventually find out about the fees, commissions, and other charges. You should be the one who tells them. Otherwise, they may lose some faith or trust in you, which could affect your other business with this prospect. Be sure to explain the tax implications to your prospects. Tell them that profits (if any) will result in a tax liability which is likely to exceed cash distributions, if any. Tell prospects about redemption charges and any penalties for early withdrawals.

A pitfall for brokers who are selling funds occurs when they have not studied the disclosure document. As a broker, you are required to understand what you are selling to determine it’s appropriateness for your customers.

Another pitfall for brokers selling funds is overstating profit potential and minimizing risk. Brokers have also overstated the benefit of diversifying with futures to reduce portfolio volatility and enhance returns. While this is a possible advantage, we remind you of the words on the front page of many disclosure documents, “Unless the investment is successful, and there can be no assurance that it will be, it cannot serve as a beneficial diversification for an investor’s portfolio.”

While we have covered many disclosures, a final pitfall is not making all the disclosures required by your compliance department. This applies to all futures products you may sell or are selling – not just funds.

There are also many pitfalls for transactional futures brokers. Compliance people and regulators said a major pitfall for you is your belief that virtually all your prospects should become your clients. Futures trading is not for everyone. Your prospects must be emotionally stable, as well as, financially stable in order to trade futures. Many new futures brokers, in the pressure to get clients, will accept almost anyone. This is a pitfall! Often the ones who should not be in futures are the easiest to open. They may be naïve, unsophisticated and unknowing. The same characteristics may improve their chances of winning a judgment against you in a court of law. Therefore, your first rule should be, don’t automatically take just anyone as a client.

Another pitfall for newer brokers trying to open transactional accounts is that they downplay or hide their inexperience. Some brokers have “rounded up” eight months of experience to “Going on two years.” Don’t misrepresent your experience. Our surveys with futures prospects indicate that a broker’s experience is not one of their major “buying criteria.” They are mostly concerned about your honesty!

New brokers have fallen into the pitfall of succumbing to the euphoria of the markets. They and their new, often inexperienced clients get caught up in the headiness of "trading futures" and go overboard. Some new brokers and new traders have become victims of the "adrenaline rush" of futures trading. It happens before you know it. How do you avoid it? Set limits, ahead of time: such as trading limits, contract limits, size limits, loss limits, money limits, use stops, slow down, ask for help, stop trading. Just be forewarned, when a new broker and a new trader get together, they can reinforce and "feed on" each other's wildness.

Understand your products before you sell them. Understand your markets before you trade them. Occasionally, new brokers will attempt to trade thin or illiquid markets. Why? Because many new brokers pride themselves on being different and look for something different to trade. This is a pitfall.

Remember, all your conversations have to comply with the regulations – even innocent telephone calls, visits or letters to family and friends telling them about your new job and the "marvelous opportunity in orange juice".
New brokers in particular are often overly enthusiastic about a trading opportunity. They feel they have to "sell" the trade. Their concept of selling is to tell the prospect all of the good and none of the bad. When selling futures you must adopt a different approach to selling. Use the approach your compliance department and the regulators say you must use. Give equal balance to the possibility of loss as well as gain.

If you're not positive about your prospect's suitability or understanding of the investment you must disclose even more. You must give honest and fair balance to every presentation. When you sell potential for profit, you must give equal emphasis to risk of loss. In fact, many experienced brokers spend more time pointing out risk of loss to their prospects.

Another pitfall is selling deep out-of-the-money options. They are relatively inexpensive and therefore easier to sell. Most of the time they expire with no value. Many compliance officers said not to sell them.

Another pitfall occurs when a prospect tries to convince a broker to get some information about someone's trading plans – often a large commercial account. The prospect's request may go something like this, "Let's see how good you are getting information to help us trade." This is a veiled attempt to get inside information. The prospect continues, "if you can help us out and your information is accurate, maybe I can steer some business your way." Don't fall for this bait.

Complaints!?! Tell your supervisor about them right away. Every moment's delay in addressing a complaint simply compounds the problem. Do not try to handle the complaint by yourself. As one compliance officer advises you, "Don't make it your problem, pass it on." She also said, "don't try any short cuts, the regulators have seen it all, they have hundreds of people and hundreds of computers looking for violations in order to protect the public. You are not going to get anything by them for long. They'll catch you sooner or later."

A final pitfall for newer futures brokers, and one of the most important, is standing by and doing nothing as a customer gets into trouble trading. The client begins losing money and starts trading unreasonably to try to get his money back quickly. He may trade more contracts or "take a shot" at contracts he knows little or nothing about. He may be indiscriminately adding to losing positions and on and on. Be alert to the possibility of this happening. If a client's trading patterns change, treat this as a warning sign.

A novice, or even an experienced client, can let trading success go to his head. This can quickly lead to wild trading. Watch for this pitfall as well. In either situation, the earlier you call in your manager, the better. It's a lot easier to avoid a deficit than collect one.

Now for a general review

Communications with the Public

The two most important things to remember are:

1. Your compliance department and/or supervisor must approve any material you communicate to the public – this includes your customers as well as prospects. A reminder: e-mail should be treated as written correspondence.
2. The National Futures Association's rules that are violated most often pertain to Communications with the Public and Sales Practices.

Financial Situation and Investment Experience of Prospects and Customers

Assume, for a moment, that your prospect is going to lose most, if not all, of the money he's putting in futures. Is it really risk capital? Can he afford the loss? Will the loss affect his life style? In the case of a transactional account, can he afford to lose more than his initial investment?

What about investment experience? Has he traded stocks? Does he realize futures are much different? Does he really understand how risky, volatile and fast our markets can be? Does he realize that most transactional futures traders lose money? Ask yourself these questions. Ask your prospects these questions.

Disclosure of Material Information

Never put a customer in a situation where he could say, "I didn't know that," or "If I had known that I wouldn't have opened the account," or "…put on that trade," or "…bought that fund," or whatever. Tell all. Just a few examples.

- You can lose more than your initial investment (non-fund accounts).
- Locked-limit markets
- Margin calls
- Commissions and fees can be significant.
- Break-even analysis
- Tax implications for fund accounts.
- Redemption restrictions (early redemption penalties)
- Errors
- Most trades will probably be losing trades.
- Most transactional traders lose.
- Add some of your own – you know your prospects best, you know what disclosures they need.

Remember, some people need additional disclosure beyond a thorough explanation of the Risk Disclosure Statement. It's up to you to find out enough about your prospect to make the determination of whether or not additional disclosure is required.

Sales Practices

Synthesizing this one is easy. Just tell your prospects everything they need to know to make an informed decision. No high-pressure. No urgency. No feigned excitement. No insinuations of great riches. Just convey the truth. That's what the best brokers do.

Conflicts of Interest

The big conflict is the one of you being a commission salesperson. You must constantly keep reviewing your motivation for recommending trades. Keep asking yourself, is this what's best for my client? The way to make a decision about any conflict of interest is to practice one of the most important tenets of our industry, the customer comes first. Whenever there is any hint of a possible conflict, you must tell yourself, the customer comes first. You know better than anyone if you're leaning towards giving yourself the benefit of the doubt. Treat your customers the way you would want to be treated. If the situation seems too close to call, ties go to the customer because, the customer comes first.

Confidentiality

Many inexperienced brokers feel a good way to gain their prospects' or clients' respect is to give them some "inside information" – real or imagined. This is one of the fastest ways for you to lose your prospects' and clients' respect. Your prospects and clients know it's inherently wrong for you to disclose "inside information." If you do, they question your integrity. On the other hand, if a prospect or client asks you, even unknowingly, for confidential information, your answer has to be something along the lines of, "Sorry, but I'm not permitted to disclose that information." Our surveys of over 3,000 futures prospects and clients have found this is one of the surest ways for you to gain credibility! Your prospects and clients know if you treat others' business confidentially, you'll treat their business confidentially. Disclosing confidences makes you look like a rookie who is trying too hard. Keeping confidences makes you look like a professional.

Managed Money

You receive no greater vote of confidence than a customer giving you Power of Attorney. Your customer has put a portion of his financial fate in your hands. This puts your relationship on an even higher plane than a conventional client/broker arrangement. It is an important test of your fiduciary responsibility!

Supervision and Internal Controls

Your supervisor is expected to help make sure you do everything we have covered in this ethics training, at a very minimum. There are literally hundreds of rules and regulations your supervisor has to know and enforce.
Remember, if a broker gets in trouble with his compliance department and/or the regulators, the supervisor is almost always blamed and held liable for the same violation under the category of, "failure to supervise."

Summary

According to most of the regulators and compliance people we surveyed the most common complaints they received from the public about brokers were:

1. Lying about profit potential
2. Lying about risk
3. Overtrading (churning)
4. Unauthorized trading
5. Didn't explain commissions and fees
6. Pressure to trade
7. Seasonal claims
8. Options transactions

In closing, "You must take ethics training to make sure you understand your responsibilities to the public under the Act…." While instinctively you know what's right and wrong when dealing with prospects and clients, we hope this course has increased your awareness of your responsibilities to the public. Yours is a difficult job. It is easy to get caught up in the frantic pace of business and do certain things almost without thinking. We also hope this material helps you stop and think about your ethical and legal responsibilities. You know the concepts: Futures trading is not for everyone and your clients come first.

Congratulations

You have completed your Initial ethics training. The Ethics Certification you earned by completing this course is valid for three years. Some compliance officers require their brokers to take an ethics course once a year or every two years! They feel it's a small price to pay to help prevent lawsuits.
Click the Sworn Declaration (SD) link below. Fill it out and hit Submit to send it to us. We'll certify you and send you your Certificate by email.
We also offer a newly formatted EZ Quick-Scroll **Anti-Money Laundering Compliance Course for $25**: no clock, no tests, no downloads, no SS# or CC# to take course (eliminates Internet Security breach and identity theft worries), no pre-payment, no password, live phone help line 24/7/365.

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