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BEFORE THE COMMITTEE ON AGRICULTURE
U.S. HOUSE OF REPRESENTATIVES

December 8, 2011

My name is Daniel Roth and I am the President and Chief Executive Officer of National Futures Association. NFA is the industrywide, self-regulatory organization for the futures industry. Our 4,000 Member firms include futures commission merchants, commodity pool operators, commodity trading advisors and introducing brokers. The recent demise of MF Global has dealt a severe blow to the public's confidence in the financial integrity of our futures markets. This is much more than an academic argument. Thousands of customers have suffered and continue to suffer from a breakdown in the regulatory protections they have come to expect. Their frustration with the situation is completely understandable. Reestablishing the public's confidence is essential to our futures markets, which, in turn, are an essential part of our nation's economy.

All of us involved in the regulatory process have to work to restore that confidence and that effort must begin with identifying and implementing regulatory changes to try to prevent such insolvencies from occurring and to better respond to them when they do occur. Even while the MF Global investigation is ongoing, we should be able to identify certain frailties of the current structure that will need to be addressed. No ideas should be off the table in this process. At the same time, though, we should not hastily discard regulatory approaches that have been historically sound and I would note that the basic concept of self-regulation has served our markets and our nation very well for a very long time. Until this investigation is complete, we will not know the full facts of exactly what went wrong at MF Global. What I do know, though, is that no system of regulation can in every instance prevent people intent on breaking the law from doing so, and that is why the Commodity Exchange Act provides that stealing customer funds is a felony punishable by up to ten years in prison. With that in mind, I would like to outline today some of the possible regulatory changes that need to be considered.

First, though, let me describe NFA's current role in the regulatory structure, in particular with regard to FCMs. Our 4,000 Member firms include approximately 70 FCMs that hold customer funds. The largest of these are members of one or more exchanges and therefore members of multiple Self-Regulatory Organizations (SROs). Pursuant to CFTC rules, the SROs have formed a Joint Audit Committee. For FCMs that have multiple SROs, the Joint Audit Committee assigns one SRO to be the primary regulator, what is referred to as the Designated Self-Regulatory Organization or DSRO. With very limited exceptions, NFA acts as the DSRO for 26 FCMs that hold customer funds and that are not clearing members of any exchange. On a daily basis each of these firms must report to NFA the amount of funds required to be held in segregation; the amount actually held; customer debit information; open trade equity for both customer and proprietary futures trading; long and short option value for customer accounts; and debits and deficits for non-customers such as employees or affiliates of the firm. Firms for which NFA is the DSRO must also file a Segregated Investment Detail Report (SIDR report). This report lists the types of investments in which customer segregated funds are held. These reports must be filed either monthly or whenever there is a material change in the information. Our systems for the daily segregation reports and the SIDR reports generate alerts whenever there is a change in information regarding segregated funds that could signal a problem with the firm.

Each FCM is also subject to two annual examinations, one by an outside CPA that produces an annual certified report and the other by its DSRO. Let me assure you that those annual examinations focus extensively on testing for segregation compliance and confirming to outside sources the segregated fund balances reported by the FCM. We also act as the exclusive SRO for all commodity pool operators, commodity trading advisors and most introducing brokers.

Although we were not the DSRO for MF Global, we participated with other members of the Joint Audit Committee to receive regular updates on MF Global's condition in the week prior to its bankruptcy. When the shortfall in customer segregated funds became known, we focused on the 5 FCMs for which we are the DSRO that had customer funds on deposit with MF Global. Our goal was to ensure that those FCMs could satisfy their obligations to their customers and that they were in compliance with all segregation and capital requirements. We worked closely with the CFTC in that effort and continue to monitor those firms, all of which appear to be in compliance.

We have also identified 150 commodity pools operated by NFA Member firms that had funds on deposit with MF Global. We have worked with those Member firms to ensure that their pool participants are receiving adequate disclosures regarding the impact of MF Global's failure on the pools and to ensure that redemption requests from participants are being handled fairly. We also have 261 introducing broker Members who either had a portion of their own capital on deposit with MF Global or who satisfied their capital requirements by operating pursuant to a guarantee agreement with MF Global. Introducing brokers do not hold customer funds. We have, though, monitored those IBs to ensure that they either have new guarantee agreements or have sufficient net capital to satisfy their regulatory requirements.

With respect to the regulatory changes that have to be considered, there are two broad issues to be addressed. First, what changes can be made to rules or regulatory practices that would be better designed to prevent customer losses due to an FCM's insolvency. Second, since we cannot completely eliminate the possibility of FCM insolvencies, how can we improve the way we handle those insolvencies to limit the impact on customers and the markets. The following list of topics is certainly not exhaustive but should be among the topics under discussion.

Prevention of FCM Insolvencies

Gross Margining—Should the CFTC require all clearinghouses to collect margin on a gross rather than net basis?

Commingling of Customer Segregated Funds—FCMs are prohibited from commingling customer funds with the firm's assets but may commingle funds from different customers in the same segregated account. Though not an issue in MF Global, this can expose customers to loss due to the default of another customer. Various alternatives to this approach have been discussed.

Monitoring for Segregation Compliance—Should SROs change the manner in which they monitor Member firms for compliance with segregation requirements? Should SROs perform unannounced spot-checks to confirm balances to outside sources more frequently? Should FCMs be required to have an independent CPA conduct unannounced segregation compliance exams annually? Should SROs periodically test to see if there have been intraday transfers of customer segregated funds that could arouse suspicion? Should information be made publicly available about how each FCM invests its customer funds?

Mandatory Excess Segregation—Most FCMs deposit some of their own funds as excess customer segregated accounts to act as a buffer in case some customers go into a debit position. Should FCMs be required to maintain a certain minimum in excess segregated funds?

Internal Controls—Should there be either specified requirements or best practice guidance on the types of internal controls that should be in place for the authorization to transfer segregated customer funds above a certain threshold level?

Third Party Depositories—Some have suggested that customer funds not needed to margin positions at the clearinghouse should be held not by the FCM but by a third party depository.

Notice to Regulators—Should an FCM be required to give notice to either its DSRO or the CFTC when the firm makes any transfer of customer segregated funds, including intraday transfers, above a certain threshold?

Responding to FCM Insolvencies

Implementation of some of the changes described above could obviate the necessity of a formalized response mechanism, such as some form of customer account insurance. On the other hand, the changes described above may not be sufficient to restore public confidence, and we need to examine the pros and cons of establishing a formalized mechanism to address customer losses due to an FCM insolvency. Any such study will have to address each of the following broad issues:

> **Goal of the Insolvency Response Mechanism**—Would the mechanism be designed to compensate customers for their losses, along the lines of a SIPC type program, or to facilitate the immediate transfer of open positions to a financially stable FCM?
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> **Administration of the Mechanism**—If there should be a formalized insolvency response mechanism in place, should it be government sponsored, administered by an industry organization or accomplished through private insurance?
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> **Funding the Mechanism**—If the response mechanism is some form of industry administered fund, the question of how to fund it depends on who would be covered. Would it be desirable to limit the beneficiaries to the public customers, i.e., non-members of the exchange of the insolvent FCM?
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> **Limitations on Compensation**—Regardless of whether the mechanism is administered by an industry group or by the government, what restrictions or limitations on customer compensation would be appropriate? Should such a mechanism follow the SIPC model and compensate 100% of customer losses up to a certain limit? Would that form of protection address the needs of the institutional participants that form the bulk of the industry's customer base? Should the mechanism make a *pro rata* distribution to customers? Should there be a limit as to the amount of coverage related to any one FCM insolvency?

We should also consider how the bankruptcy laws should apply to a firm that is both an FCM and a broker-dealer but is primarily engaged as an FCM. That is the fact pattern here and we should consider whether a SIPC administered bankruptcy proceeding is the most appropriate means of dealing with such an insolvency.

The basic point here, Mr. Chairman, is that there is work to be done. The failure of MF Global will require significant regulatory changes to bolster public confidence in our markets. The list of possible options is long. The issues are complex and their importance is profound. The process of weighing those choices must be deliberate and careful but we must not lose time in starting that review. NFA hopes to play a constructive role in that process and we look forward to working with the industry, the CFTC and with Congress to ensure that what emerges is a better regulatory model.