



**TESTIMONY OF DANIEL J. ROTH  
PRESIDENT AND CHIEF EXECUTIVE OFFICER  
NATIONAL FUTURES ASSOCIATION**

**BEFORE THE COMMITTEE ON AGRICULTURE OF THE  
UNITED STATES HOUSE OF REPRESENTATIVES**

**October 2, 2013**

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Chairman Conaway, Ranking Member Scott, Members of the Committee, thank you for the opportunity to testify at this important hearing. My name is Daniel Roth and I am the President of National Futures Association. As Congress begins the reauthorization process, customer protection issues should be front and center in everybody's mind. Customer protection is the heart and soul of what we do at NFA, and for years the futures industry had an impeccable reputation for safeguarding customer funds. Since Congress last considered reauthorization, though, that reputation has taken a serious hit. First at MF Global and then at PFG, customers suffered very real harm from shortfalls in customer segregated funds, the kind of harm that all regulators seek to prevent. Clearly, dramatic improvements had to be made. In the wake of MF Global and PFG, NFA has worked very closely with the CME, other self-regulatory organizations and the CFTC to bring about those improvements. In my testimony today I would like to describe some of the improvements that have already been made, discuss the CFTC's proposed customer protection rules and suggest changes to the Commodity Exchange Act that would strengthen customer protections in any FCM bankruptcy proceeding.

**REGULATORY IMPROVEMENTS**

**Daily Confirmation of Segregated Account Balances**

For years, NFA and other SROs confirmed FCM reports regarding the customer segregated funds held by the FCM through traditional paper confirmations mailed to the banks holding those funds. These confirmations were done as part of the annual examination process. In early 2012 NFA began confirming bank balances electronically through an e-confirm process. That change led to the discovery of the fraud at PFG, but e-confirms were still done as part of the annual examination. We had to find a better way and we did.

We partnered with the CME and developed a process by which NFA and the CME confirm all balances in all customer segregated bank accounts on a daily

basis. FCMs file daily reports with NFA and the CME, reflecting the amount of customer funds the FCM is holding. Through a third-party vendor, NFA and CME get daily reports from banks for the over 2,000 customer segregated bank accounts maintained by FCMs. We then perform an automated comparison of the reports from the FCMs and the reports from the banks to identify any suspicious discrepancies. In short, Mr. Chairman, the process by which we monitor FCMs for segregated fund compliance is now far ahead of where it was just one year ago.

We have recently expanded this system to also obtain daily confirmations from clearing firms and will expand it again by the end of the year to include clearinghouses as well.

### **FCM Transparency**

One of the lessons we learned from MF Global is that customers should not have to study the footnotes to an FCM financial statement to find out how their segregated funds are invested or other financial information about their FCMs. We had to make it easier for customers to do their due diligence on financial information regarding FCMs. For years, NFA required FCMs to file certain basic financial information with NFA, and that information is now posted on NFA's website for customer review. The information includes data on the FCM's capital requirement, excess capital, segregated funds requirement, excess segregated funds and how the firm invests customer segregated funds. This information is displayed for each FCM and includes historical information in addition to the most current data. The display of FCM financial information on NFA's website began in November 2012 and so far these web pages have received over 25,000 hits.

### **MF Global Rule**

All FCMs maintain excess segregated funds. These are funds deposited by the FCM into customer segregated accounts to act as a buffer in the event of customer defaults. Because these funds belong to the FCM, the FCM is free to withdraw the excess funds, but after MF Global, NFA and the CME adopted rules to ensure notice to regulators and accountability within the firm. Now all FCMs must provide regulators with immediate notification if they draw down their excess segregated funds by 25% in any given day. Such withdrawals must be approved by the CEO, CFO or a financial principal of the firm and the principal must certify that the firm remains in compliance with segregation requirements. This rule became effective on September 1, 2012.

### **FCM Internal Controls**

NFA, CME and other SROs developed more specific and stringent standards for the internal controls that FCMs must follow to monitor their own compliance with regulatory requirements. In May 2013, NFA's Board approved an interpretive notice that contains specific guidance and identifies the required standards

in areas such as separation of duties; procedures for complying with customer segregated funds requirements; establishing appropriate risk management and trading practices; restrictions on access to communication and information systems; and monitoring for capital compliance. NFA submitted the interpretive notice to the CFTC on May 22, 2013, for its review and approval.

### **Review of NFA Examination Procedures**

NFA's Special Committee for the Protection of Customer Funds—consisting of all public directors—commissioned an independent review of NFA's examination procedures in light of the PFG fraud. The study was conducted by a team from the Berkeley Research Group ("BRG") that included former SEC personnel who conducted that regulator's review of the SEC's practices after the Madoff fraud. BRG's report was completed in January 2013. The report stated that "NFA's audits were conducted in a competent manner and the auditors dutifully implemented the appropriate modules that were required." The report, however, also included a number of recommendations designed to improve the operations of NFA's regulatory examinations in the areas of hiring, training, supervision, examination process, risk management, and continuing education. All of the recommendations of the BRG report have been addressed and, as a result, NFA has:

- Revised and beefed up its examination modules regarding segregated funds, capital compliance, internal controls and the exam planning process;
- Made staffing changes so that experienced managers and directors spend more time in the field for every examination;
- Increased its recruiting and hiring of more experienced examiners; and
- Made further improvements to its training programs.

### **Certified Fraud Examiner Training**

At the end of the day, the examinations performed by SROs in the futures industry are not about crossing "T"s and dotting "I"s—they are about detecting violations of SRO rules—including anti-fraud rules. That is why we have greatly expanded our use of the training programs of the Association of Certified Fraud Examiners. Becoming certified as a fraud examiner involves extensive training, testing and continuing education requirements. In the last year over half of our staff has obtained the certification and we are now requiring all of our compliance staff to obtain that certification.

## **STRENGTHENING CUSTOMER PROTECTIONS IN FCM BANKRUPTCY PROCEEDINGS**

Both the PFG and MF Global bankruptcies highlighted the need for greater customer protections to not only guard against the loss of customer funds but also in the event of an FCM's insolvency. As discussed above, NFA has made and continues to implement changes to enhance the safety of customer segregated funds and guard against a shortfall in customer funds in the event of any future FCM failures.

NFA believes, however, that Congress should consider a statutory change to strengthen customer protections and priorities in the event of a future FCM bankruptcy. Over 30 years ago the CFTC adopted rules regarding FCM bankruptcies. Among other things, those rules provided that if there was a shortfall in customer segregated funds, the term "customer funds" would include all assets of the FCM until customers had been made whole. Several years ago, a district court decision cast doubt on the validity of the CFTC's rule. That decision was subsequently vacated but a cloud of doubt lingers. Congress can and should remove that doubt about the priority customers should receive if there is a shortfall in segregated funds and can do so by amending Section 20 of the Act. Section 20 gives the CFTC authority to adopt regulations regarding commodity brokers that are debtors under Chapter 7 of Title 11 of the United States Code. We would suggest an amendment to clarify the CFTC's authority to adopt the rule that it did. We believe there is a broad base of industry support for this approach and would be happy to work with Congress on specific proposed language.

## **CFTC'S PROPOSED CUSTOMER PROTECTION RULES**

NFA worked closely with the CFTC staff in developing many of the regulatory improvements described above. The Commission also proposed its own changes to customer protection rules in a 107-page Federal Register release last year. Certain parts of the Commission's proposals have provoked strong opposition both from the industry and from end users of the markets, particularly in the agricultural sector. As described below, NFA shares many of the concerns raised by others, but we fully support many of the Commission's proposals. For example, the Commission's proposed rules would:

- Require SROs to expand their testing of FCM internal controls and develop more sophisticated measures of the risks posed by each FCM;
- Require that FCM certified annual financial reports and reports from the chief compliance officer be filed within 60 days of the firm's fiscal year end;
- Require that an FCM that is undercapitalized provide immediate notice to the Commission and its DSRO; and

- Require each FCM to establish a risk management program designed to monitor and manage the risks associated with the FCM's activities.

Other provisions of the Commission's proposals, however, raise serious concerns, particularly with regard to the so-called "residual interest" issue. FCMs have always maintained an amount of its own capital in customer segregated accounts to act as a buffer for customers who fail to meet their margin obligations in a timely manner. This amount is often referred to as the FCM's "residual interest" in the segregated account. The Commission has now proposed that all FCMs must maintain at all times a residual interest sufficient to exceed the sum of all margin deficits that the customers in each account class have. Essentially, FCMs would have to assume that every customer will default on every margin call and maintain capital in the segregated account to cover that possibility.

Several points need to be made on this proposal. First, it has absolutely nothing to do with the problems encountered at either MF Global or PFG. Neither of those cases had anything to do with customers failing to meet margin calls. Second, this is the first time in the Commission's 39-year history that it has ever taken the position that the Act requires FCMs to assume that all customers will default on all margin calls. Third, the underlying assumption that in this day and age no customers meet margin calls by writing checks is wrong. Agricultural hedgers frequently meet their margin calls with checks. Fourth, the impact of this proposal could be devastating for both agricultural end users and the relative handful of FCMs that service those customers. Customers will have to post much more margin funds with their FCMs or the FCMs will have to maintain much more capital in their business. Either way, there will be fewer customers using futures markets to hedge and fewer FCMs handling their accounts. This proposal does not just fix something that is not broken, it threatens to do real harm to a longstanding system that has worked well for both customers and the markets.

The Commission has also proposed new requirements for SROs, most of which we support. However, the Commission's proposals blur important distinctions between the annual examinations of FCMs performed by CPAs and those performed by SROs. Each year an FCM must have a certified financial audit performed by a CPA. The CPA issues a report expressing an opinion with respect to the FCM's financial statements or issues an Accountant's Report on Material Inadequacies. The SRO examination, on the other hand, focuses on FCM compliance with the rules of the CFTC and the SRO. Certainly, there are areas of overlap between the two examinations but there are also marked differences in focus and purpose. The Commission proposes that an SRO apply Generally Accepted Auditing Standards to every aspect of its FCM examination, not just in those areas where the SRO and CPA exams overlap. This is overbroad and will add unnecessary costs and burdens to the examination process.

## **CUSTOMER ACCOUNT INSURANCE STUDY**

The failures of MF Global and PFG have generated renewed calls for some form of customer account insurance. Abstract discussions of this question do not help answer the two key questions: what type of insurance would be available and what would it cost. To answer those questions NFA joined with FIA, CME and the Institute for Financial Markets to sponsor the study being conducted by Dr. Christopher Culp, who is also a witness at today's hearing. Dr. Culp is awaiting pricing proposals from London reinsurance companies that would be part of a private sector solution.

Dr. Culp's research on this issue has been thorough and methodical. Based on his data, we would agree with his preliminary conclusions that for the vast majority of customers at the larger FCMs various forms of customer account insurance would be of little or no interest and that, given the size of these larger customers, the cost of a mandatory insurance program for all customers of all FCMs would be cost prohibitive, whether sponsored by the government or by the private sector. Dr. Culp's research thus far, though, indicates that for smaller FCMs with customers who maintain smaller balances there may be a voluntary private sector solution. Ultimately, the viability of that option will depend on the price quotes for reinsurance and on the demand for the product among smaller FCMs and their customers. We look forward to Dr. Culp's final report.

## **CONCLUSION**

Detecting and combating fraud is central to our mission. No system of regulation can ever completely eliminate fraud, but we must always strive for that goal. The process of refining and improving regulatory protections is ongoing and the initiatives outlined above do not mark the end of our efforts. We look forward to working with Congress, the CFTC, SROs and the industry to ensure that customers have justified confidence in the integrity of the U.S. futures markets.