



May 1, 2013

The Honorable Debbie Stabenow  
Chairwoman  
U.S. Senate Committee on Agriculture, Nutrition, and Forestry  
328A Russell Senate Office Building  
Washington, DC 20510

The Honorable Thad Cochran  
Ranking Republican Member  
U.S. Senate Committee on Agriculture, Nutrition, and Forestry  
328A Russell Senate Office Building  
Washington, DC 20510

Dear Chairwoman Stabenow and Ranking Member Cochran:

Thank you for your March 7th letter requesting NFA's input and recommendations relating to CFTC Reauthorization. Your letter correctly highlights that this year's reauthorization comes at an important, but challenging time as the CFTC continues to implement the Wall Street Reform and Consumer Protection Act and markets are evolving rapidly and face extraordinary regulatory and market pressures. Your letter further states that the failures of MF Global and Peregrine Financial Group ("PFG") raise questions about how better to protect customers, which is critically important and the essence of what we do.

### **Customer Protection Initiatives**

For years, the futures industry had an impeccable reputation for safeguarding customer funds deposited at FCMs. Within a very short time frame, we had a shortfall in customer segregated funds at two FCMs and ensuing bankruptcies. Customers at both firms suffered real harm, the type of harm that all regulators attempt to prevent. These customer losses are a reminder that regulators must continuously improve surveillance, examination and fraud detection techniques to keep pace with changing technology and an ever-more-complicated global financial marketplace. Since the PFG and MF Global cases, we have worked closely with the CFTC and other self-regulatory organizations (SROs) to adopt a number of initiatives to further safeguard customer funds.



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**Daily Confirmations from all Segregated Funds Depositories**—NFA and the CME Group, along with the IntercontinentalExchange Inc. and Minneapolis Grain Exchange, developed and implemented a system that requires all depositories holding customer segregated funds on behalf of an FCM to directly report balances daily to SROs. The SROs perform an automated comparison to the daily reports filed by the FCMs to identify any suspicious discrepancies. In February 2013, Phase 1, which centered on the confirmation of customer segregated funds held by bank depositories, was completed. In March 2013, NFA and CME Group commenced Phase 2 of the monitoring system which will focus on confirming balances for customer segregated funds held in non-bank depositories, mainly accounts held at clearing FCMs and clearinghouses. Phase 2 is scheduled for completion in late summer 2013.

**MF Global Rule**—All FCMs are now required to provide regulators with immediate notification if they draw down their excess segregated funds (funds deposited by the firm into customer segregated accounts to guard against customer defaults) 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 Transparency**—All FCMs must file certain basic financial information about the firm with NFA and that information will be posted on NFA's web site. 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. The public display of FCM financial information on NFA's website provides investors with another tool to help them conduct due diligence before choosing an FCM. The investing public is now able to visit NFA's website to obtain general information about an FCM, publicly available disciplinary information and financial information. The display of FCM financial information on NFA's website began in November 2012, and these web pages have received over 15,000 hits.

**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 Berkeley Research Group ("BRG"), and former SEC personnel who conducted that regulator's review of the SEC's practices after the Madoff scandal. BRG's report was completed in January 2013. The report stated that "NFA's audits



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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. NFA has already taken a number of steps to implement BRG's recommendations. A Special Committee appointed by NFA's Board will oversee the timely implementation of these recommendations.

**Internal Controls Guidance**—NFA, CME Group 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. NFA has drafted an interpretive notice that contains specific guidance and identifies the minimum required standards for internal controls in a number of areas such as separation of duties; the firm's procedures for complying with customer segregated and secured amount funds requirements; establishing and complying with appropriate risk management and trading practices; restrictions on access to communication and information systems; and monitoring for capital compliance. NFA will submit the interpretive notice to the CFTC shortly for its review and approval.

### **Study Regarding Customer Account Insurance**

In light of the failures of MF Global and PFG, there have been growing calls for some form of customer account insurance. This issue has not been analyzed in detail since NFA performed an insurance study in 1985. Therefore, FIA, the Institute for Financial Markets, the CME Group and NFA have undertaken an industry-funded customer account insurance study. The study will not include recommendations for or against any form of insurance but will analyze and estimate the potential costs and assess the potential benefits of several possible forms of a customer account insurance program. The study is scheduled for completion in late spring/early summer.

### **FCM Bankruptcy Reform**

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.



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NFA believes, however, that the CFTC Reauthorization process should be used to pursue a number of possible changes to Bankruptcy Code provisions that govern an FCM's liquidation that would likely strengthen customer protections and priorities in the event of a future FCM bankruptcy. We fully recognize that any changes to the Bankruptcy Code regarding FCM insolvency protections will not be easy to achieve during CFTC Reauthorization due to Congressional Committee jurisdictional issues. Yet we strongly believe that the two recent FCM failures have highlighted the need for enhanced customer protections that can only be achieved via changes to the Bankruptcy Code.

We are in discussions with all facets of the industry to arrive at a consensus view on changes that should be made. Chief among NFA's concerns in this area is removing the uncertainty raised by the court in the Griffin Trading Company bankruptcy so that "customer property" is clearly defined going forward to include an FCM's general estate assets so that in instances where customer assets are insufficient alone to satisfy customer claims, then customers should receive first priority to the FCM's general estate assets until customer claims are paid in full. Other issues may include reviewing whether it is appropriate that all joint FCM/broker-dealer bankruptcies be administered under SIPA.

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 will continue to work with Congress, the CFTC, SROs and the industry to ensure that customers have justified confidence in the integrity of the U.S. futures markets.

I welcome the opportunity to visit with you to discuss any of the material in our response.

Sincerely,

A handwritten signature in black ink, appearing to read "Daniel J. Roth", is written over a faint, larger version of the same signature.

Daniel J. Roth  
President