

**TESTIMONY OF DANIEL J. ROTH  
PRESIDENT AND CHIEF EXECUTIVE OFFICER  
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**BEFORE THE COMMITTEE ON AGRICULTURE, NUTRITION AND FORESTRY  
UNITED STATES SENATE**

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My name is Daniel Roth and I am the President and Chief Executive Officer of National Futures Association. NFA is the industry wide self-regulatory organization for the U.S. futures industry. Basically, any firm doing business with the public on a U.S. futures exchange is required to be a member of NFA. Our 4000 member firms include Futures Commission Merchants, Introducing Brokers, Commodity Pool Operators and Commodity Trading Advisors. We also regulate the activities of the 50,000 account executives that are registered as associated persons of our member firms. NFA adopts rules to require members to deal fairly with their customers; we monitor members for compliance with those rules through investigations, surveillance and examinations; and we take disciplinary action against members that fail to comply with those rules. In all of these areas we work very closely with the CFTC as our oversight agency. Over the years, this partnership has led to extraordinary results. Since NFA began operations in 1982, volume on U.S. futures exchanges is up by over 2000% but during that same period of time customer complaints in the futures industry have actually dropped by over 70%.

Now it seems likely that NFA's responsibilities could be expanded significantly as a result of the CFTC's Dodd-Frank rule making. Specifically, the CFTC has proposed regulations that could expand NFA responsibilities in three areas:

- The CFTC has proposed delegating to NFA the responsibility for processing applications for registration as swap dealer and major swap participant, conducting the background checks on those applicants and their principals and, as appropriate, granting or denying those applications;
- The CFTC has also proposed requiring all registered swap dealers and major swap participants to become members of NFA and requiring NFA to monitor those members for compliance with regulatory requirements; and
- Under Dodd-Frank, swap execution facilities will have certain surveillance and self regulatory responsibilities. The CFTC has proposed allowing SEFs to outsource those functions to other registered entities, such as NFA.

In my testimony today I would like to discuss each of these areas and describe the challenges facing NFA and the steps we have taken and are taking to meet those challenges.

## **Registration of Swap Dealers and Major Swap Participants**

Over the years the CFTC has delegated to NFA virtually all of the registration responsibility for all of the categories of registration under the Commodity Exchange Act. All applications for registration as FCMs, CPOs, CTAs, IBs, associated persons, floor brokers or floor traders must be filed with NFA. NFA performs an extensive background check on each application based on the qualification standards set forth in Sections 8a(2) and (3) of the Act and, as appropriate, either grants or denies the application. All of NFA's adverse registration actions are subject to review by the CFTC. It was not surprising, then, that the CFTC has proposed delegating the registration responsibility for swap dealers and major swap participants to NFA as well. When the CFTC first proposed the delegation, NFA began working on the changes to our web based registration system to accommodate these new categories of registration. Those programming changes have been completed and NFA is now in a position to begin accepting and processing applications as soon as the CFTC adopts final rules regarding registration and the definitions of "swap dealers" and "major swap participants."

The trickier part of the registration process will involve the submissions each applicant firm must make as the CFTC's rules promulgated under Section 4s of the Act become effective. The Commission's proposed registration rules contemplate that firms may apply for registration before all of the Section 4s requirements have become effective. In these situations, firms can be granted a "provisional registration." As each Section 4s requirement becomes effective, the firm would be required to submit to NFA written policies and procedures designed to ensure that the firm will be in compliance with the applicable Section 4s requirement. Once all of a firm's Section 4s submissions have been reviewed and approved, the firm would be granted a full registration. If NFA determines that the submissions are not adequate the firm's provisional registration would be withdrawn.

As each Section 4s requirement is phased in, NFA will be receiving fairly voluminous submissions from each firm applying for swap dealer or major swap participant registration. To review these submissions in a timely and meaningful way NFA will need to augment its existing staff, prepare detailed guidance for the NFA staff conducting the reviews and temporarily divert resources from other compliance functions to the review of the submissions. Obviously, we cannot complete the guidance for NFA staff reviewing the Section 4s submissions until the Commission adopts rules in their final form. We have, though, begun preparing the guidance based on the proposed rules and will work closely with the Commission staff in that process. I should also point out that a number of swap dealer firms have been most generous with their time to provide training to both NFA and CFTC staff regarding some of the nuts

and bolts aspects of their operations, which will be a great help in developing the Section 4s guidance for our staff.

## **Regulation of Swap Dealers and Major Swap Participants**

Before NFA can undertake the regulation of swap dealers and major swap participants, we have to address three basic issues: governance, funding and audit modules.

### **Governance**

NFA cannot begin regulating swap dealers and major swap participants until those firms become NFA members and they cannot become NFA members until NFA amends its articles of incorporation to create those categories of membership. We cannot amend the articles of incorporation until we determine the necessary changes to our governing structure to ensure the fair and adequate representation of swap dealers and major swap participants on NFA's Board of Directors. Boiled to its essence, the governance issue involves devising a system of checks and balances to ensure that the futures industry representatives on NFA's board cannot adopt rules to place OTC derivatives at a competitive disadvantage and that the OTC derivative representatives on the Board cannot adopt rules to, in effect, give themselves a free pass.

NFA's Board has appointed a Swap Dealer Advisory Committee to work with NFA's Special Committee on Governance to develop recommended changes to NFA's governing structure. Any amendments to NFA's articles of incorporation must be approved first by NFA's Board, then by NFA's membership and, finally, by the CFTC. We are hopeful that we can present the proposed changes to NFA's Board this summer. That will depend, however, on the CFTC's adoption of final definitions of the terms "swap dealer" and "major swap participant," since it would be impossible to determine issues on board representation until we know the actual definitions of the appropriate categories.

### **Funding**

NFA now has three main areas of regulatory responsibility: regulation of intermediaries involved with exchange traded futures, trade practice and market surveillance on behalf of certain futures exchanges and the regulation of off exchange retail forex dealers. We have consistently applied three basic principles regarding the funding of our activity in each of these areas:

- Each regulatory activity has to pay its own way. We do not, for example, want fees generated by exchange traded futures to subsidize our regulation of off exchange retail forex dealers. Each area must generate sufficient revenue to cover NFA's direct expenses, an allocated share of NFA's overhead and a pro rata contribution to NFA's reserves.

- We try not to take any more money out of the market than necessary. NFA's Board approves our budget each year and tries to maintain reserves at between 10 and 14 months of operating expenses. When reserves climb above 14 months of operating expenses, we cut fees; when they fall below ten months we raise fees. Thankfully, over the years we have been able to cut fees more often than we have had to raise them.
- In addition to being fair and equitable, any structure of fees and dues must be easy for members to administer.

We expect to apply these same principles with respect to OTC derivatives. Representatives of our Swap Dealers Advisory Committee will be working with NFA's Finance Committee to develop recommendations regarding dues and fees. Obviously, we will not know for certain the actual cost of performing these regulatory activities until we know how many firms actually become registered, how often they need to be audited and how long those examinations might take. As a starting point for our discussions, however, we are assuming that over time we will need to nearly double the size of our compliance department, bring on over 100 additional employees and incur costs of over \$25 million each year.

### **Audit Modules**

At some point NFA will be conducting examinations of swap dealer members. For swap dealers that do not have a prudential regulator NFA will be monitoring those members for compliance with the full range of CFTC regulations, including recordkeeping, margin, capital requirements and business conduct standards. For those that do have prudential regulators we will not be monitoring for compliance with capital and margin requirements but would still be doing so for other Section 4s requirements.

To do this job we will, as described above, need to hire individuals with extensive experience with these products and train teams of auditors to conduct the examinations. It is not just a question of building a staff, however. We also need to construct the audit modules that examiners can use in the field to test for compliance with each of the substantive areas of regulation. Building the modules is a significant undertaking in and of itself and obviously cannot be completed until the rules themselves are in final form. As the rules are adopted we will develop the necessary audit modules, working closely with the CFTC in that process.

Finally, I should note that our regulation of OTC derivatives will involve other categories of registration beyond swap dealers and major swap participants. Dodd-Frank amended the definitions of commodity pool operators, commodity trading advisors, introducing brokers and futures commission merchants to include activities regarding swaps in each definition. It remains to be seen how many firms will have to

apply for registration as a result of these definitional changes, but these new members will be engaged in business that is quite different in some ways than traditional CPOs, CTAs and IBs. We will need to carefully consider how both our rules and our audit modules will need to change to reflect that reality.

### **Surveillance Activities on Behalf of Swap Execution Facilities**

Dodd-Frank establishes certain core principles for swap execution facilities, including obligations to perform certain self regulatory responsibilities. Many potential SEFs have no self regulatory infrastructure in place. Therefore, the CFTC proposed allowing SEFs, like designated contract markets, to outsource certain self regulatory responsibilities to registered futures associations. NFA has been performing trade practice and market surveillance functions on behalf of futures exchanges for over ten years. During that time the CFTC has performed numerous reviews of NFA's surveillance functions and has always been fully satisfied with NFA's performance.

NFA has been contacted by numerous potential SEFs that are interested in outsourcing certain self regulatory responsibilities to NFA. We recognize that swap execution facilities will operate on a much different business model than contract markets and that significant changes to our surveillance programs will be necessary for NFA to perform that function. The first step in making those changes is to identify the data elements that NFA will have to receive from the SEFs in order to perform a meaningful surveillance function. After internal meetings, extensive discussions with several SEFs and meetings with the CFTC staff, we have identified 170 data elements that need to be built into our system. We have hired additional help in our information systems department so that we can make the necessary changes to our surveillance programs and are in the process of doing so.

Depending on how many SEFs contract with NFA, we anticipate that we will have to dramatically increase the size of our current surveillance staff, though the timing of that expansion will depend on CFTC implementation dates for SEFs. We have also begun to develop a formal schedule of the regulatory services NFA could provide to SEFs and a schedule of fees designed to ensure that NFA recovers its costs. Once NFA has signed agreements with SEFs, it might be difficult logistically to ensure that NFA could start performing regulatory services for all of the SEFs that seek NFA services on the same day. We are hopeful that a phased in approach to SEF regulatory requirements will ensure that the order in which NFA begins performing regulatory services for SEFs does not create a competitive advantage for any particular SEFs.

One of the difficult issues that still needs to be addressed involves cross market surveillance. NFA may conduct surveillance for some SEFs but probably not all. Certain types of abuses could be perpetrated across multiple SEFs. Detecting those types of abuses will require close coordination between the regulators, the swap data repositories and the SEFs. At this time, it is unclear exactly how that coordination will be accomplished and who will have both the ability and responsibility to detect those

abuses. We will work closely with the Commission in any way we can to address this issue.

## **Conclusion**

Over the last 29 years, NFA's primary mission has been to partner with the CFTC in creating a robust and efficient regulatory environment for the U.S. futures industry. These are challenging times for both regulators and the derivatives industry. We are confident that we can continue our tradition of working closely with the Commission and with the industry to be part of the solution for many of the vexing problems that lie ahead.

/ckm(Testimony Senate Ag 6-11)