



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

**BEFORE THE UNITED STATES SENATE COMMITTEE  
ON AGRICULTURE, NUTRITION & FORESTRY**

**July 17, 2013**

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Chairwoman Stabenow, Ranking Member Cochran, 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. Let me start by highlighting the steps we have already taken.

**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, Madam Chairwoman, the process by which we monitor FCMs for segregated fund compliance is now far ahead of where it was just one year ago.

We are working with the CME to expand this system to also obtain daily confirmations from other types of depositories, such as clearing firms and clearinghouses. That expansion should be complete by the fourth quarter of this year.

### **Customer Account Insurance**

In light of the failures of MF Global and PFG there have been renewed calls for some form of customer account insurance. As we begin this discussion, we should bear in mind three points. First, customer account insurance can take many forms. There are alternatives to the SIPC, government sponsored model. Private insurance solutions can take several forms in terms of who is covered and to what extent. Second, public confidence in the markets is critical, but it is a means to an end. The real goal is to ensure that futures markets are effective and efficient and a benefit to the economy. Markets must therefore be liquid and that requires public confidence. However, attempting to bolster public confidence through insurance programs that prove to be cost prohibitive is self-defeating and would damage the liquidity we are trying to foster. Finally, this question is too important to be dismissed out of hand because various forms of insurance might be too expensive.

We need data, not hunches. We need to know what kind of insurance we would be buying and what we would be paying for it. Only then can Congress make an informed decision. With this in mind, NFA has joined with the CME, FIA and the Institute for Financial Markets to commission a detailed analysis of various alternative approaches to customer account insurance. Armed with detailed customer account information from small, medium and large FCMs, the study will calculate the estimated costs of each of the alternatives studied. We hope to have the results of the study by mid-September.

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

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 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. 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 over the validity of the CFTC's definition of customer property. 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 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.