



**TESTIMONY OF THOMAS W. SEXTON  
PRESIDENT AND CHIEF EXECUTIVE OFFICER  
NATIONAL FUTURES ASSOCIATION**

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

**June 25, 2019**

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Chairman Roberts, Ranking Member Stabenow, Members of the Committee, thank you for the opportunity to testify at this important hearing. I am the President of National Futures Association. For those new to the Committee, NFA is the industrywide self-regulatory organization (SRO) for the derivatives industry. Our membership includes swap dealers (SD), futures commission merchants (FCM), commodity pool operators (CPO), commodity trading advisors (CTA), introducing brokers (IB), retail foreign exchange dealers and all of the associated persons of intermediary firms. NFA's Membership currently numbers approximately 3,500 Member firms and close to 50,000 associated persons. NFA's responsibilities include registering all firms and industry professionals on behalf of the Commodity Futures Trading Commission (Commission or CFTC), passing rules to ensure fair dealing with customers, monitoring Members for compliance with those rules and taking enforcement actions against those Members that violate our rules. Every aspect of our regulatory authority is closely overseen by the CFTC.

As the industry SRO for the derivatives market, we have one overriding objective—to help the CFTC. Although we work independently of the CFTC, we are subject to CFTC oversight, and we and the CFTC act as strong partners in regulating the derivatives industry. Over the years, the CFTC has asked for our assistance and delegated a number of responsibilities to NFA. For example, besides the registration process, the CFTC has delegated to NFA the responsibility for reviewing all CPO and CTA disclosure documents, CPO annual pool financial statements and swap valuation dispute information from SDs. We communicate daily with the CFTC on a number of regulatory issues and closely coordinate with them. For example, we meet regularly with the CFTC's Division of Enforcement to coordinate our investigatory resources and also with the Division of Swap Dealer and Intermediary Oversight on our exam process and rule development. Moreover, if our exams or investigations uncover emergency situations, then we immediately coordinate our responses with the CFTC.

The Commission's responsibilities are enormous and we will continue to help in any way we can. At this time, I certainly want to thank CFTC Chair Giancarlo for his support of

NFA and self-regulation over his past five years serving as a CFTC Commissioner. Additionally, as the CFTC transitions to new leadership under Dr. Tarbert, we certainly look forward to working with Chair Tarbert and applaud the Senate's confirmation of him a few weeks ago. Similarly, we also applaud this Committee's work to give the CFTC a full five member Commission, which we believe brings a diversity of views and knowledge to confront today's regulatory challenges and enables the CFTC to successfully carry out its important work.

Reauthorization is always an important process for the industry as a whole and for NFA in particular. NFA firmly believes that customer protection issues should be front and center as Congress works to reauthorize the CFTC. The last few reauthorization bills voted out of this Committee and the House Agriculture Committee have included a key customer protection provision relating to FCM bankruptcies, which we continue to strongly support. I would first like to address this provision and reiterate the reasons for our strong support. The remainder of my testimony will discuss changes to NFA's oversight responsibilities, cyber security and customer protection issues that we have addressed with the CFTC's support since the CFTC's formal authorization expired in September 2013.

### **Strengthening Customer Protections in FCM Bankruptcy Proceedings**

As I mentioned, a key customer protection provision relating to FCM bankruptcies has been included in previous reauthorization bills voted out of this Committee and the House Agriculture Committee.

NFA fully supports this provision, which would strengthen customer protections and provide customers with priority in the event of an FCM bankruptcy, and we urge this Committee to include this key statutory change in any future reauthorization bill. 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. Although that decision was subsequently vacated, a cloud of doubt continues to linger over the validity of the CFTC's rule. Congress should remove that doubt and ensure that customers have priority if there is a shortfall in segregated funds, and can do so by amending Section 20 of the Commodity Exchange 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 suggest that Congress amend Section 20 to clarify that the CFTC has the authority to adopt the rule that it did. We believe there is a broad base of industry support for this approach, and we would be happy to work with Congress on specific proposed language.

### **Changes to NFA's Oversight Responsibilities**

In light of Dodd-Frank, NFA's responsibilities have grown significantly and it is a much different organization today than in 2013. By raw numbers, NFA's budget in FY 2013

was \$63.2 million and in FY 2020 it will be \$107.2 million. Our employees numbered approximately 331 in FY 2013 and today we have 536 employees. Although the majority of that increase is attributable to staffing our OTC Derivatives Department to oversee SD Members (as described below), we also significantly increased our Technology Department to both support the OTC Derivatives Department, as well as address other technology and cyber security related issues. Specifically, NFA's Technology Department grew (90%) from 59 employees in 2013 to the current staff of 112 for FY 2020. The technology budget also grew significantly (140%) from \$10.2 million for FY 2013 to \$24.4 million for FY 2020.

### **Swap Dealer Members**

The most significant change to NFA's self-regulatory role occurred in late 2012 when we assumed regulatory authority over SDs after the CFTC required them to become NFA Members. We currently have over 100 SD Members, the vast majority of which are either large U.S. banks or financial institutions, foreign banks or affiliates of one of these entities. In FY 2020, SDs are projected to contribute approximately \$33 million to fund NFA's oversight of their activities. Since late 2012, we have added over 100 employees as we developed our SD regulatory oversight program, which has the following major components:

*Policy and Procedure Reviews*—Beginning in early 2013, we worked closely with the CFTC to review the policies and procedures for all 100 new SD registrants. Our review was extremely detailed in nature and was designed to ensure that each SD had adopted written policies and procedures to ensure that it complied with the CFTC's Implementing Regulations under Section 4s of the Commodity Exchange Act.

*Examinations*—We performed our first examinations of SDs in 2014, and since then we have examined all U.S. SDs and nearly all non-U.S. SDs for compliance with NFA's Rules, which adopt the CFTC's core requirements applicable to SDs. In examining non-U.S. SDs, we work cooperatively with the CFTC and non-U.S. regulators and have performed on-site examinations in the U.K., Australia, Canada and Sweden. Our examinations of U.S. SDs have focused on regulatory requirements related to the chief compliance officer function, risk management, business conduct standards, SDR reporting and the segregation of counterparty collateral. In light of the CFTC's substituted compliance framework, our examinations of non-U.S. SDs have focused on a narrower subset of these areas.

*Data Collection*—In January 2018, we started collecting monthly market and credit risk data from SDs and standardized data for swap valuation disputes (SVD). The risk data metrics allow NFA to monitor the SDs' risk exposures by requiring them to report monthly risk metrics, including value at risk, credit valuation adjustments, market sensitivities, current exposures and the exposure to their fifteen largest counterparties. The SVD data includes detailed

information about the dispute including the counterparties involved, dispute amount and date of resolution, if any. The monthly risk and SVD data is available to the CFTC, and we use the data to identify firms that may pose heightened risk.

*Margin Model Approvals*—The CFTC's margin rules for uncleared swaps allow SDs subject to the CFTC's rules to choose between calculating initial margin using a standardized grid or an internal risk-based model approved by the CFTC or NFA. The CFTC's rules have a five-year implementation period based on the size of an SD's swaps business. In early 2016, the CFTC requested that NFA approve the use of SDs' initial margin models, which required NFA to perform a detailed review of each SD's model to determine if it met the standards set forth in the CFTC's margin rules. To complete these reviews, we hired staff with quantitative expertise, engaged consultants and worked closely with the CFTC. We subsequently approved the initial margin models of more than 30 of the largest SDs by the first implementation date of September 1, 2016. Since that time, we have approved models of a few additional SDs with later implementation dates and newly registered SDs immediately subject to the CFTC's margin rules. We are currently working with several smaller SDs that are seeking model approval by the final implementation date of September 1, 2020. We have also developed and implemented an oversight program to assess whether each SD's ongoing use of the model is in compliance with NFA's approval conditions and the CFTC's margin rules.

NFA's SD oversight program is just over six years old, and we will continue to evaluate and enhance this program as necessary in the future.

### **Swap Execution Facilities**

Dodd-Frank required the registration of swap execution facilities (SEF), which are electronic trading platforms for swaps. These SEFs are SROs and have an obligation to surveil their markets. Since the early 2000s, we have contractually offered to perform certain surveillance functions on behalf of electronic futures markets. After Dodd-Frank, many SEFs requested that NFA perform similar functions for them. To do this work, we tripled the size of our Market Regulation Department, which performs these services for contract markets and SEFs. Today, we perform market surveillance for 13 SEFs, which among them have 97% of the SEF traded interest rate market and close to 100% of the SEF traded CDS index market. In performing these services, we work closely with the SEFs acting as SROs and the CFTC's Division of Market Oversight.

We also applaud the CFTC's willingness to review the SEF trading structure five years after SEF trading was launched. NFA does not operate a market and is not a market participant and, therefore, we did not comment on many of the market structure issues in the CFTC's November 2018 proposal. We did, however, express concerns about some portions of this proposal since we felt they would seriously erode regulatory accountability over individuals and firms that accept or solicit orders for swaps

transactions. We look forward to further discussing those issues with the CFTC if necessary.

## **Cyber Security**

Cyber security is an issue that is of critical importance to all of us—Congress, regulators, market participants and the general public. Currently, security comprises over 20% of our technology budget and similar to most organizations, this cost continues a steady rise. NFA makes every effort possible to secure our technology systems and protect NFA Member data and data held on behalf of the CFTC. In doing so, we adopted best practice frameworks and standards (*i.e.*, National Institute of Standards and Technology and the Center for Internet Security) to form a foundation that supports prompt security risk assessment and mitigation. We also engage independent third parties to perform security testing. Last year, we engaged two independent examiners to perform separate reviews of our security program. The first, our annual security assessment, focused on the technical aspects of NFA's applications and network infrastructure, and the second, the SOC2 Certification audit, focused on the framework of policies and procedures that serve as the foundation for NFA's security program. We constantly stress the need for our staff to adhere to our security protocols, and our security measures are constantly reviewed by our security compliance and applications development staff, by NFA's Board and by the CFTC.

Technology and expert security personnel assist greatly in mitigating NFA's cyber security risks. However, not holding unnecessary data in the first place is the best mitigation of risk. We continually assess whether the sensitive data we collect is necessary for us to fulfill our regulatory responsibilities, and if it isn't then we stop collecting it. Moreover, we use our best efforts to delete sensitive data when the regulatory need no longer exists.

Like NFA, our Member firms face cyber security risks each day. Our Members range in size from large multinational corporations with sophisticated security programs to sole proprietorships. In 2015, NFA's Board imposed specific cyber security requirements on NFA Members by requiring them to have a written information systems security program (ISSP). Although we allow Members flexibility to adopt specific measures appropriate for their business and size, all Members are required to conduct a security and risk analysis, deploy protective measures against identified threats and vulnerabilities, develop a response and recovery plan from threatening events, train their employees and review their programs at least every twelve months. Since making the ISSP requirements effective in early 2016, we have worked with our Members during examinations to ensure that they comply, and we have made further changes to the requirements that we felt were appropriate. For example, we recently imposed a requirement that Members notify NFA of certain breaches involving their commodity interest business and implemented a more comprehensive cyber security examination program that includes additional testing of Members' cyber security readiness. Given the nature of this threat, we will continue to be vigilant about Members' compliance with our cyber security requirements.

## **Customer Protections Issues**

Detecting and combating fraud is central to our mission. No system of regulation can ever completely eliminate fraud, but we must always strive to achieve that goal. We are constantly working to refine and improve regulatory protections. Given the evolving nature of the derivatives industry, we are currently engaged in a review of NFA Requirements to ensure that they appropriately address the commodity interest activities of all our Members and recently amended our existing rules that were limited to futures activities to cover SDs and the swaps activities of all Members.

At this time, I will highlight just a few of the customer protection issues we have addressed since the CFTC's formal authorization expired in September 2013. The CFTC's assistance in addressing these issues was critical.

*Oversight of Firms*—Our employees are committed to protecting customers and safeguarding the derivatives markets. They understand that the examinations NFA conducts on our Member firms are not just about crossing "T"s and dotting "I"s—they are about detecting violations of NFA rules—including our anti-fraud rules. To that end, the vast majority of our compliance professionals are certified fraud examiners, which involves extensive training, testing and continuing education requirements. Moreover, in 2016, NFA and CME Group engaged a consultant and worked with the CFTC to develop a set of examination standards that conform to applicable auditing standards issued by the Public Company Accounting Oversight Board. NFA examiners follow these standards to carry out examinations, and these standards help ensure that our exams are reliable, accurate and consistent.

*Safeguarding Customer Funds*—All FCMs that hold customer funds report their customer segregated, secured and cleared swaps collateral funds balances to NFA or CME Group daily. In 2013, NFA and CME Group phased in a process to confirm all these balances on a daily basis by obtaining confirmation information directly from depositories. We also perform detailed reviews during our examinations of an FCM's internal controls, and since CPOs also hold customer funds we recently adopted a requirement, reviewed by the CFTC, that CPOs implement an internal controls framework that is designed to protect customer funds, produce reliable and accurate financial statements and ensure that the CPO is in compliance with CFTC and NFA requirements.

*Swaps Proficiency Requirements*—Individuals engaging in swaps activities with customers and counterparties should meet basic proficiency requirements. NFA is currently developing proficiency requirements for individuals acting as APs at SDs and those registered APs engaged in swaps activities at our intermediary firms. These requirements will be in the form of an online learning program that consists of a series of modules, each with a training and testing component. NFA's Swaps Proficiency Requirements will launch in January 2020 with a

Compliance Date of January 31, 2021. The CFTC has supported this initiative and reviewed NFA's rules to effectuate these requirements.

*Virtual Currencies*—In late 2017, a number of CFTC regulated trading venues launched derivatives on virtual currency products, including bitcoin. NFA, working with the CFTC, issued an investor advisory so customers fully understood the nature of virtual currencies and virtual currency derivatives, the substantial risk of loss related to these products given their volatility and the limitations of NFA's regulatory authority over spot market virtual currency products. We subsequently adopted additional requirements, which required NFA Members engaged in these products to provide detailed additional disclosures to customers. Through specific reporting requirements, we carefully monitor our Members' activities in these products, which have been modest to date.

*Regulatory Coordination*—Approximately 760 NFA Member CPOs are also registered with the SEC as investment advisers (IA). We firmly believe that the expertise to oversee these firms' derivatives activities is much different than the expertise to oversee their securities activities, and therefore it is essential that CFTC/NFA and the SEC continue to carry out their respective regulatory oversight of these entities. However, we support a framework that maximizes regulatory coordination including a formal process for NFA and the SEC to share examination schedules and reports for dually registered CPOs/IAs and conduct joint examinations when feasible. NFA also supports streamlined reporting for dually registered CPOs/IAs by permitting these firms to file either Form PQR with the CFTC or Form PF with the SEC with the agencies sharing the information. We look forward to working with the CFTC and SEC on these coordination efforts.

In conclusion, NFA's mission today is the same as it was thirty-seven years ago. Our overriding objective is to help the CFTC to protect customers, protect market integrity and protect the public's confidence in the derivatives markets. We are proud of our regulatory partnership with the CFTC, and we will work closely with Congress and the Commission to respond to the regulatory challenges posed by an industry that is constantly changing. I would be happy to answer any questions.