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January 23, 2006

Via e-mail: [secretary@cftc.gov](mailto:secretary@cftc.gov)

COMMENT

Jean A. Webb  
Secretary  
Commodity Futures Trading Commission  
Three Lafayette Center  
1155 21<sup>st</sup> Street, N.W.  
Washington, DC 20581

RECORDS SECTION

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Re: Self Regulation and Self-Regulatory Organizations

Dear Ms. Webb:

NFA welcomes the opportunity to address the Commission's recent questions on self-regulation and self-regulatory organizations. NFA has always been a strong supporter of self-regulation and we believe it is the best model for regulation in the futures industry. That having been said, NFA also recognizes that there may be enhancements that can be made to the current system to make it an even stronger regulatory framework. We commend the Commission for nearing a conclusion to its study of the self-regulatory process.

Since NFA does not operate a market, and is a not-for-profit organization, it does not face many of the issues confronting exchange-SROs. As a result, a number of the issues raised in the Commission's request do not apply to NFA. We will limit our comments in this letter to those issues that directly affect NFA.

**Question 1** – Is the present system of self-regulation an effective regulatory model for the futures industry?

**Answer** – The present system of self-regulation in the futures industry, with a number of SROs under direct Commission oversight, has proven effective as evidenced by the explosive growth in the market in a relatively scandal free environment. Self-regulation has also allowed the Commission to focus its resources on areas that self-regulation can't reach, such as enforcement actions against unregistered firms and individuals. NFA believes that self-regulation, subject to appropriate government oversight, achieves a number of important goals, including maximizing regulatory effectiveness, minimizing regulatory burdens and saving taxpayers' money.

**Question 4** – What is the appropriate composition of SROs' boards of directors to ensure the fairness and effectiveness of their self-regulatory programs?

**Answer** – The most important guiding principle for board composition is that the board should be diverse so that no one constituency of the SRO, including the public, can dominate board actions. An SRO's board should represent the interests of all the SRO's constituents, including members of the SRO and the public. Any conflicts of interest that arise from having SRO members on the board should be managed by ensuring that there are appropriate checks and balances in board composition, not by eliminating the market expertise offered by members.

SRO members are an important component on any SRO's board. The knowledge and experience that these individuals bring to the board is critical. There are often several ways to address a regulatory issue, and SRO members are usually the best qualified to determine which method will address the issue most efficiently – providing the necessary protection to customers and other members while minimizing the burdens on regulated individuals and entities.

SRO members should also have a voice in how they are regulated. Not only are SRO members knowledgeable, they also have a real interest in ensuring that the self-regulatory process works and that the public has confidence in the integrity of the markets and the system. Their knowledge, combined with their interest in a successful self-regulatory process, help to ensure that the process is both fair and effective.

It is also important to remember that in many instances, the members of an SRO can be subdivided into different categories based on the nature of their business. Each category should be represented on the board because they represent different interests and may approach issues with a different perspective. It may also be appropriate to subdivide categories based on other factors, such as size. In many instances, the interests of a large firm are different than the interests of a small firm.

NFA's Board provides one model for this type of structure. Our Board is comprised of representatives from contract markets, FCMs, IBs, CPOs, CTAs and the public. The contract market, FCM and CPO/CTA categories require that a certain number of representatives come from firms based on the size of the Member – ensuring that both large and small entities are represented. The IB category requires that one IB board member represent guaranteed IBs and the other represent independent IBs.

As discussed more fully in Question 5, public directors also play an important role on an SRO's board. Participation by public directors ensures representation for the retail public and other end users who must have confidence in the way the

market operates. Again, however, the board should be structured to ensure that they do not dominate the actions of the board.

The underlying principle for determining board composition should require that an SRO have a diverse board that represents the interests of all the SRO's constituents, including the public, and incorporates appropriate check and balances so that no one constituency can dominate the board.

**Question 5** – Should SROs' boards include independent directors, and, if so, what level of representation should they have? What factors are relevant to determining a director's independence?

**Answer** – NFA strongly believes that an SRO's board should include non-member directors. NFA's Board has always had public representatives, and their participation is an important protection for those market participants – primarily retail customers and other end users – who are not otherwise represented on NFA's board. While we believe that all SROs should have public directors, one size does not fit all, and who qualifies should depend on the particular SRO. Strong Commission oversight, however, must be present to ensure that an SRO's public representatives are appropriately diverse and adequately represent the interests of non-members.

At NFA, a public director is one who is not an officer, director, partner, employee or beneficial owner of more than 10 percent of the equity stock of any NFA Member. This definition allows for a diverse group of public directors. NFA's public directors have included bankers, academics, former Congressmen, and end-users, among others. We believe that there should be diversity within the public representative category, but we do not believe that the category should be limited to individuals without any industry connections. Many of our public representatives have been individuals with industry experience or affiliations, such as end-users and a former CFTC chairperson. NFA has found that public representatives with industry experience have brought unique perspectives to the board and have made many positive contributions to NFA's success.

**Question 6** – Should self-regulation be overseen by an independent entity within an SRO? If so, what functions and authority should be vested in such an entity? At least two futures exchanges have implemented board-level regulatory oversight committees ("ROCs") to oversee their regulatory functions in an advisory capacity. Commenters are invited to address any strengths or weaknesses in this approach.

**Answer** – An independent committee is one way to manage conflicts of interest between an SRO's regulatory functions and its market functions. However, it is not the only solution and certainly not the most efficient solution for some SROs. At NFA, for example, regulation is all that we do, so that is the only function our board oversees. Therefore, creating a separate committee to oversee NFA's regulatory functions would be redundant. We do believe, however, that our

regulatory activities should be fully transparent to our board, so we provide our board with an annual report of our regulatory activities.

**Question 8** – What is the appropriate composition of SROs' disciplinary committees to ensure both expertise and impartiality in decision-making?

- i. Should a majority of committee members be independent? Should the composition of SROs' disciplinary committees reflect the diversity of the constituency? Should similar safeguards apply to other key committees and if so, which committees?
- ii. Should SRO disciplinary committees report to the board of directors, an independent internal body, or an outside body?

**Answer** – Members must be involved in the disciplinary process because they bring a depth of knowledge that public representatives do not have. As with board composition, however, no one constituency should control an SRO's disciplinary process, and disciplinary committees and hearing panels should be structured so that neither the respondent's colleagues nor its competitors control the decision to issue (or not issue) a complaint or determine the outcome of the proceeding. Since non-members are neither colleagues nor competitors, including them on disciplinary committees and hearing panels helps to strike the proper balance.

CFTC Regulation 1.64(c) requires NFA to have at least one non-member on each disciplinary committee and hearing panel that considers an action against a board or disciplinary committee member. NFA Compliance Rule 3-17 conforms to that requirement but goes much further by requiring each three person hearing panel to include at least one non-Member regardless of the type of case or whether the action is against an NFA board or disciplinary committee member. Compliance Rule 3-17 further directs the Chairman of the Hearing Committee to appoint panelists with diverse interests. In addition, NFA Bylaws 704 and 707 require, respectively, that at least one-third of the members of NFA's Business Conduct Committee and Hearing Committee be persons who are not Members or Associates or employees of Members. NFA believes that using non-members on hearing panels not only enlarges the pool of qualified individuals from which we can draw but also enhances the perception of fairness.

NFA does not believe, however, that disciplinary committees and hearing panels should be required to have a majority of non-members or a non-member chairperson. Diverse disciplinary committees and hearing panels and appropriate limitations on a chairperson's authority to act alone provide all the checks and balances necessary.

NFA's disciplinary committees do not report to any body, although they are appointed by the Board. All decisions of the disciplinary committees are subject

to a full review process, including appellate rights to an Appeals Committee that is a subset of the Board and, from there, to the Commission.

**Question 9** – What information should SROs make available to the public to increase transparency (e.g., governance, compensation structure, regulatory programs and other related matters)? Are the disclosure requirements applicable to publicly traded companies adequate for SROs?

**Answer** – The SRO process must be transparent to ensure that participants have confidence in the markets. NFA has always strived to make all material information readily available to both our Members and the public. NFA's Manual and website include the names and affiliations of all members of our Board of Directors, all its standing committees, and NFA's disciplinary committees. Significant actions taken by the Board – including committee appointments and mid-term Board replacements – are reported in the membership newsletter after each Board meeting, and the newsletter is posted on the website where it is accessible to the public. Rule submissions are also posted on NFA's website, as well as the entire Rulebook.

Information on NFA disciplinary proceedings is also readily available to Members and the public. Decisions issued in disciplinary and membership cases and membership responsibility actions taken by the Executive Committee are posted in our BASIC system and are searchable by year and rule number, as well as by respondent. Complaints and answers are also included in BASIC, and all pleadings are available to the public upon request.

**Question 11** – What conflict of interest standards, if any, should be applicable to third party regulatory service providers, including registered futures associations, to ensure fair, vigorous, and effective self-regulation on their part?

**Answer** – Government designation and oversight of exchanges, and the exchanges' and service providers' own self-interests provide the best insurance against conflicts of interest. A service provider that does not do an effective job will soon find itself without any clients – either because the exchange is dissatisfied with the ability to ensure the integrity of the exchange's markets or because the CFTC will take action against the exchange for failure to meet the core principles that are a condition of its designation.

NFA believes that the framework in which NFA provides regulatory services also guards against potential conflicts. First, NFA prices its regulatory services to merely recover the costs associated with providing the service. Since NFA does not make any profit in providing these services, we have little economic interest in keeping clients satisfied by not investigating matters or recommending disciplinary action.

In addition, NFA's Regulatory Services Agreement ("RSA") requires an exchange that does not follow our recommendations on investigating a matter or initiating a disciplinary action to provide a written explanation to NFA as to why the exchange disagrees with NFA's recommendation. This creates a clear paper trail that the CFTC can review in connection with a rule enforcement audit or at any other time upon request. Additionally, each RSA contains a relatively short termination provision whereby NFA can terminate the RSA without cause if it disagrees with an exchange's regulatory decision.

Again, NFA commends the Commission for continuing this important work and providing NFA and others with the opportunity to address these important questions. If Commission staff would like to further discuss these issues, please do not hesitate to contact me at (312)781-1413.

Sincerely,

Thomas W. Sexton, III  
Vice President and General Counsel

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