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My name is Daniel Roth, and I am President and Chief Executive Officer of National Futures Association. Thank you Chairman Gensler and Chairman Schapiro and the other CFTC and SEC Commissioners present today for this opportunity to present our views on the harmonization of market regulation. NFA is the industry-wide self-regulatory organization ("SRO") for the U.S. futures industry. Our approximately 3,800 Members include futures commission merchants ("FCMs"), introducing brokers ("IBs"), commodity pool operators ("CPOs") and commodity trading advisors ("CTAs"). We also regulate approximately 53,000 registered account executives who work for our Members.

By their very nature, SROs live with overlapping jurisdiction issues every day. At NFA our jurisdiction always overlaps the CFTC's, frequently the futures exchanges' and occasionally the SEC's. We have dealt with those issues through intense coordination to the benefit of customers and markets. Since NFA began operations in 1982, volume on U.S. futures markets has increased over twenty fold from 140 million futures and options contracts in 1983 to 2.9 billion contracts traded last year. What most people do not realize is that during that same time period, customer complaints in the futures industry are down by almost 75%. This drop in customer complaints was not an accident. It was the result of a close partnership between NFA and the CFTC, other financial regulators, exchange SROs, and law enforcement to make sure that we allocate resources where they are most needed, that we do not duplicate each other's efforts and that precious regulatory resources are not squandered.

Enforcement Challenges

Though a primary focus of today's hearings are differences in the regulation of futures and securities, we should not lose sight of all that we share in common. We are all regulators and all face the same types of challenges and problems. I would like to talk, first, about the enforcement challenges we face at NFA and, later, what we see as gaps or inconsistencies in the current structure.

As a self-regulatory organization, NFA has two basic jobs. For Members that want to comply with their regulatory requirements, our job is to help them comply. For those Members that do not want to comply, our job is to identify them quickly and get rid of them. Three years ago we decided we needed to do a better job at identifying problem firms and ensuring that problem firms got our highest priority. Specifically, we knew that there were two areas where we could improve.

First, we had to get better at connecting the dots. We have information about our Member firms from a wide variety of sources—audits, annual questionnaires, registration files, disclosure documents, customer complaints, arbitration demands and internet surveillance, to name a few. We have to constantly review all of those data points to identify patterns of behavior that do not add up. At times, after we would close a firm for fraud, we would realize that we had information in one pocket of NFA that could have tipped us off sooner to the problem. We just did not have all of the dots on the same screen where we could see them. Once all of the dots are on the same screen, we have to be better at connecting them. It's not enough to look for patterns we have seen before or to wait for computers to identify the potential problems. We need to be smart with our technology but we also need to exercise judgment, to be inquisitive when we see something unusual, to be alert for any pattern of conduct that should raise our suspicion. Second, when we do connect the dots, we have to realize that it is not enough to put a suspect firm on the audit schedule—we have to be there tomorrow.

To improve in each of these areas we undertook three initiatives. First, we completely overhauled our computerized risk management system to ensure that all of the information NFA has is fed into a program that can produce a more complete risk profile for every firm. Second, we created a Risk Management Group to research, identify and test new risk factors on an ongoing basis to enhance our risk models and identify problems more quickly. Third, we restructured our Compliance Department to ensure that we would always have a quick strike capability when problem firms are identified.

The results of these changes over the last three years have been encouraging. In the past three years, we doubled the number of enforcement actions we have taken and tripled the number of Member Responsibility Actions. These MRAs are emergency actions taken to stop an ongoing fraud and really highlight the importance of coordination with other regulators. As a member organization, NFA cannot freeze assets held by a non-member. Through our MRAs we are usually trying to hold the fort until a government regulator can obtain more complete relief in court. Over the last few years, our MRAs led to over 20 CFTC actions in federal court and several SEC actions. These cases may have involved overlapping jurisdiction, but with close coordination among regulators, overlapping jurisdiction can serve customers well.

One recent example of the benefits of overlapping jurisdiction and close coordination is NFA's MRA against commodity pool operators Stephen Walsh and Paul Greenwood in February 2009. NFA closely coordinated and assisted the CFTC, SEC, and federal criminal authorities in this matter. Within four weeks after NFA began an audit of those firms, NFA issued an MRA alleging that these two individuals operated a Ponzi scheme that misappropriated hundreds of millions of dollars in pool funds, the CFTC and SEC filed civil actions and federal criminal authorities filed a complaint against the two.

Our enforcement coordination with the CFTC extends well beyond MRAs. Senior staff in NFA's compliance and legal departments meet with senior management in the CFTC's enforcement division quarterly to review and coordinate open investigations. The purpose of the meeting is to avoid duplication of effort and efficiently allocate resources. Our coordination efforts generally work extremely well. CFTC and NFA enforcement staffs also meet quarterly with representatives of the FBI and the Postal Inspectors to discuss possible criminal referrals.

In short, in our experience overlapping jurisdiction is not an impediment to customer protection as long as the regulators are willing to work hard at coordination to avoid duplication and to share information.

Regulatory Gaps

From a customer protection point of view, I am not concerned when multiple regulators have jurisdiction—I am much more concerned when no regulator has clear jurisdiction. There has been confusion over regulatory jurisdiction regarding retail forex trading since the CFTC was created in 1974. The Treasury Department was concerned that the CFTC's exclusive jurisdiction could interfere with the thriving interbank market in foreign currency trading. To avoid that result, Congress passed the so-called Treasury Amendment, which provided that nothing in the Act would apply to transactions involving, among other things, foreign currencies.

Boiler rooms popped up, selling off-exchange foreign currency futures to unsophisticated, retail customers. The CFTC prosecuted those fraud cases successfully for a time, arguing that the Treasury Amendment was never intended to apply to retail customers. In 1996, the 9th Circuit Court of Appeals decided in the Frankwell Bullion case that the Treasury Amendment meant what it said and that the CFTC had no jurisdiction to protect retail customers from fraud in off-exchange forex futures.

Congress tried to right this wrong in the Commodity Futures Modernization Act of 2000. Essentially, Congress provided that the CFTC did have regulatory jurisdiction over forex futures contracts involving retail customers, unless the counterparty was a bank, a broker-dealer, a futures commission merchant or an insurance company.

This solution was dealt a crippling blow, though, in 2004 when the 7th Circuit ruled in the Zelener case that in deciding whether a retail forex transaction was a futures contract, the form of the written agreement with the unsophisticated customer was more important than the substance of the transaction. Provided that they included certain words in the fine print of their customer agreements, fraudsters could evade CFTC jurisdiction by disguising their off-exchange futures contract as a "rolling spot."

As it is wont to do, the scammer element exploited this latest opening and fraud again flourished in the retail forex market. Congress tried again to clear the air in May 2008 by providing that the CFTC had antifraud authority over these futures look-alike contracts in retail forex. I wish I could tell you that all was now right with the world, but it is not.

There are still two significant regulatory gaps related to this issue. First, there was nothing in the Zelener decision that limited its application to forex products. If a fraudster can write a Zelener contract for forex, he can write one for gold, natural gas or any other commodity. Predictably, after Congress clarified the CFTC's antifraud authority over forex contracts, we saw a surge in Zelener-type contracts for gold and other precious metals. We are aware of dozens of completely unregulated firms hawking these products to retail customers, and we have received complaints from customers who have lost their life savings to these fraudsters. We were pleased to see that the Treasury Department's proposed legislation addresses this issue.

We also need, though, a more complete response to the Zelener decision. Currently, if an off-exchange forex transaction with a retail customer is deemed to be a futures contract, the only permissible counterparties are regulated entities, such as FCMs and broker-dealers and banks. If that same sort of trade includes the magic Zelener language, though, the CFTC has antifraud authority but the counterparty is completely unregulated. That makes no sense. We believe it is better to prevent fraud than to prosecute it and feel that at a minimum all counterparties to Zelener-type forex transactions should be regulated entities.

Harmonization Issues

We have carefully compared our customer protection rules to those in the securities industry and have found, not surprisingly, that the comparable rules are strikingly similar in both their objectives and their approaches. However, there are a number of areas in which the rules differ. In some instances, the differences are more apparent than real, but in others there are substantive differences.

Suitability/Know-Your-Customer Requirements

As previously noted, NFA's number one priority is customer protection, and our rules governing broker sales practices play a crucial role in achieving that goal. In 1985, NFA adopted a Know-Your-Customer rule (NFA Compliance Rule 2-30) that provides protections comparable to FINRA's suitability rule but that are tailored to the unique requirements of the futures industry. Since all futures contracts are highly volatile and risky instruments, our rule requires that a suitability determination be made on a customer-by-customer basis, rather than trade-by-trade. It makes no sense to say that a customer is suitable for a recommendation to invest in heating oil futures but not in Treasury note futures. In general, our rule requires Members to obtain basic information about each prospective customer and determine whether futures trading is appropriate for each customer. The rule imposes an affirmative obligation to inform customers in appropriate circumstances that futures trading is simply too risky for that customer.

We recognize that FINRA's Rule 2310 requires a member in recommending a securities transaction to have reasonable grounds for believing that the recommendation is suitable for the customer based upon the customer's securities holdings and financial situation and needs. FINRA's rule certainly makes sense for an industry in which investors can purchase a wide variety of securities with varying degrees of risk potential that serve very different investment objectives. We feel that NFA's approach to the issue is based on the distinct nature of futures contracts and provides comparable regulatory protections.

Forex Capital and Margin Requirements

As mentioned above, both broker-dealers and FCMs are eligible counterparties in retail forex transactions. Our understanding is that there has been a limited amount of broker-dealer activity in the forex arena. For the most part, NFA and FINRA rules regarding forex are very similar. In fact, in November 2008, FINRA advised its members that their forex activities were governed by its rule requiring members to observe just and equitable principles of trade. The notice also stated that FINRA would look to NFA's forex rules in applying that standard. NFA and FINRA forex rules do differ, though, regarding capital requirements and margins.

NFA noted that FCMs offering off-exchange forex transactions to retail customers have certain risks not associated with exchange-traded futures. In short, forex FCMs play the roles of FCM, exchange and clearinghouse. We also noted that in 1978 Congress set a $5 million capital requirement for options dealers, based on those same distinctions. When adjusted for inflation, NFA determined that $20 million would be an appropriate minimum capital requirement for forex FCMs and Congress included such a provision in its May 2008 amendments to the Act. It is our understanding that neither the SEC nor FINRA imposes any special capital requirements for broker-dealers engaged in retail forex transactions.

With respect to forex margin requirements, FINRA in early June 2009 filed for approval with the SEC proposed Rule 2380 that prohibits its members from permitting a retail customer to initiate any OTC forex position with a leverage ratio of greater than 1.5 to 1. Thus, at the time a customer initiates a forex position, the customer must deposit at least 2/3 of the notional value of the contract. FINRA explains that its proposed rule seeks to limit investor losses resulting from small changes in the exchange rate of a foreign currency and reduce the risk of excessive speculation.

NFA's OTC retail forex financial requirements follow the custom of lower margins in the futures industry, which views margin as a good faith security deposit rather than as a means of protecting customers from taking speculative positions. NFA's security deposit requirements for OTC forex transactions are similar to futures exchange requirements and are set at either 1% or 4% of the transaction's notional value depending upon the currency.

Hedge Fund Adviser/CPO Registration

In mid-June 2009, the Treasury Department issued a somewhat detailed report entitled "Financial Regulatory Reform" ("FRR"), which calls for all advisers to hedge funds whose assets under management exceed some modest threshold to register with the SEC under the Investment Advisers Act. The report also discussed harmonization and calls for coordination between the CFTC and SEC regarding hedge fund adviser/CPO regulation. In mid-July, Treasury issued draft legislation that is designed to implement the FRR's recommendations regarding hedge funds. The draft legislation also calls for the CFTC and SEC to jointly promulgate rules to specify the type of reports to be filed with the respective agencies to monitor for potential systemic risk.

In the event legislation is enacted requiring hedge fund advisers to register as investment advisers, close coordination between the CFTC and SEC will be critical. Among other things, both agencies will have to decide whether a person registered with one agency should be exempt from registration with the other. NFA believes that registration and regulation of hedge fund advisers and CPOs should serve one or more of three basic goals—preservation of market integrity, avoidance of systemic risk, and protection of customers. In the futures markets, the main tools used to preserve market integrity are large trader reporting and market surveillance by both the CFTC and exchanges, neither of which depend on registration. Therefore, requiring CPO registration for any SEC registered hedge fund adviser does not add in any significant manner to the preservation of market integrity.

For customer protection and systemic risk issues, though, CPO registration adds value in instances in which the adviser has a fund that does a significant amount of futures trading, even if the harmonization process ensures that the CFTC and SEC rules for these investment advisers and CPOs provide comparable regulatory protections. NFA believes that regulatory oversight is not about reviewing a checklist for technical compliance with rules. As noted above, the important task is to identify anomalous behavior that may be indicative of suspicious activity. That, in turn, requires knowledge of futures industry norms in a wide range of areas that can only be drawn from the experience and expertise currently residing in the CFTC and NFA. Therefore, NFA suggests that persons who operate a fund in which futures trading exceeds the *de minimis* levels set forth in CFTC Regulation 4.13(a)(3)(ii) be required to register as a CPO, regardless of whether they are also required to register as an investment adviser with the SEC. NFA also suggests that the SEC adopt a *de minimis* exemption from investment adviser registration for registered CPOs. NFA believes that CFTC Regulation 4.13(a)(3)(ii) may be a useful guide for determining the appropriate *de minimis* threshold.

FCM/Broker-Dealer Capital Requirements

Finally, we wanted to touch upon the area of FCM/BD capital requirements. From our vantage point as a futures industry SRO, we believe that the CFTC for many years now has been at the forefront of adopting and utilizing risk-based capital rules that truly reflect the specific risk posed by a firm's operations. NFA believes that the Commission's current FCM capital requirements work exceptionally well with the segregation and secured amount requirements and special provisions of the Bankruptcy Code in protecting customers against insolvency losses. Currently, however, an FCM/BD's capital requirement is established by using a simplistic formula—the requirement is equal to the greater of the CFTC or SEC capital requirement.

NFA recognizes that the recent financial crisis has justifiably heightened concerns among all regulators that financial institutions have adequate capital appropriate for their specific business risk. Treasury's FRR calls for firms identified as Tier 1 Financial Holding Companies ("Tier 1 FHCs") due to their size, leverage, and interconnectedness to be subject to robust consolidated regulation and supervision. The FFR also calls for the Federal Reserve Board to have the authority and accountability for consolidated supervision and regulation of these Tier 1 FHCs, and for Treasury to lead a working group with participation by other federal financial regulatory agencies to conduct a fundamental reassessment of the existing capital requirements for banks, bank holding companies ("BHC"), and new Tier 1 FHCs. Treasury's review is to be completed by December 31, 2009, and is to focus on all elements of the capital framework, including composition of capital, scope of risk coverage, relative risk weights, and calibration.

NFA believes that most large FCM/BDs are either part of a BHC or will be classified as part of a Tier 1 FHC. Therefore, NFA encourages both the CFTC and SEC to closely coordinate any review of existing FCM/BD capital requirements with Treasury's reassessment of existing capital requirements for BHCs and Tier 1 FHCs. In the past, all financial regulators have had a tendency to use simple capital formulas that have worked well in most cases but may not have appropriately addressed a firm's specific risk. We should take this opportunity now to reflectively reassess our past approaches and determine whether a new capital framework can more adequately measure an FCM/BD's specific risk. As always, NFA offers its assistance in this endeavor.

A recurring theme in all of the testimony you will hear and in most of the proposals for regulatory reform is the need for increased coordination between the CFTC and the SEC. At NFA we know first hand that it is easier to talk about coordination than it is to do it. We all tend to think that our way is the best way and respond defensively when alternative approaches are suggested. That mindset will be fatal to any coordination effort and under the current circumstances failure is not an option. We also recognize that coordination is not a one time event. It is not over once rules are written. Coordination must be a part of our daily routine, an ingrained part of our corporate culture. We recognize that the tasks before you are difficult and are ready to offer our assistance in any way we can.

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