NFA NATIONAL FUTURES ASSOCIATION

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Via E-Mail (Secretary@cftc.gov)

Ms. Jean A. Webb
Secretary
Commodity Futures Trading Commission
Three Lafayette Centre
1155 21st Street, N.W.
Washington, DC 20581

COMMENT

Re: SRO Governance

Dear Ms. Webb:

NFA is, and has always been, a strong supporter of self-regulation. Self-regulation – subject to appropriate governmental oversight – maximizes regulatory effectiveness while minimizing regulatory burdens and saving taxpayers money. Using industry committees to develop rule proposals provides the expertise to ensure that the rules are tailored to the problem – making them practical as well as effective. Including industry personnel on disciplinary committees brings a depth of knowledge to the process that members of the public simply do not have. Self-regulation also frees up Commission resources for use in other areas, such as enforcement actions involving unregistered firms and individuals.

Despite the vital role that self-regulation plays, recent scandals in the securities industry have prompted both intense scrutiny and an examination of the self-regulatory process. While these scandals have not touched the futures industry or created pressure to review self-regulatory practices in this industry, former Chairman Newsome took the opportunity to voluntarily initiate a review of the self-regulatory processes that are subject to the Commission's oversight. NFA commends the Commission for undertaking this review. Since the CFTC's inquiry is not scandal-driven, it presents a prime opportunity to objectively examine how changes in the industry – e.g., demutualization of exchanges, the emergence of for-profit exchanges, and the changing roles of FCMs – affect the conflicts of interest inherent in the self-regulatory process and to analyze the best ways to manage those conflicts of interest.

An inevitable result of self-regulation – and its biggest criticism – is the inherent tension between the regulatory interests of the self-regulatory organization (SRO) and the business interests of the SRO as well as the members who sit on committees that develop rules or consider disciplinary matters. This tension may increase when the SRO operates a market or has other economic interests that are separate from its regulatory interests.[1] As the Commission recognizes, these conflicts of interest must be managed if the SRO is to provide effective regulation while treating both market participants and members fairly.

The Commission's release on SRO governance addresses one way of managing these conflicts. Adopting sound governance principles is not sufficient by itself, however. The Commission must work with the SROs to ensure that there is proper allocation of responsibilities between the SROs, and the Commission must also provide strong government oversight. All three of these components, working in conjunction with each other, are essential to managing conflicts of interest.

Since NFA does not operate a market, we are in a different position than most other SROs and do not face many of the competitive conflicts they face. All SROs need sound governance practices, however. Therefore, NFA firmly believes that any governance principles the Commission adopts should be broad enough to cover all SROs – including NFA – and flexible enough to accommodate differing SRO models (e.g., exchange or non-exchange, demutualized or for-profit).

Given NFA's unique position as a non-exchange SRO, a number of the issues raised in the Commission's request do not apply to it. We will limit our comments in this letter to those issues that directly affect NFA.

A. Board Composition

In order to ensure the credibility of the self-regulatory process, all market participants – including those regulated by the SRO – must have faith in that process. Market participants must be confident that the markets are well regulated – that there are tough rules in place, meaningful surveillance to ensure compliance with those rules, and vigorous enforcement actions if those rules are violated. Merely deterring wrongful conduct is not enough, however. Self-regulation is most effective when those persons regulated by the SRO believe in the fairness of the entire SRO process, from rulemaking to enforcement. Proper board composition is essential to ensuring this credibility.

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[1] In the long term, an SRO's marketplace and economic interests should coincide with its regulatory interests, since market participants will not use a market unless they have confidence in it. It is only the SRO's short-term – and short-sighted – interests that may be in conflict.

Question 1 – What is the appropriate composition of SRO boards to best protect the public interest and serve SROs' needs? If you believe that SRO boards should consist of market participants, what participant communities should be represented and how should representation be allocated among those communities (e.g., quotas, volume-based)? Should the composition of SRO boards be different for the various types of SROs (e.g., DCM or DCO)?

Answer – NFA believes that 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. The principal method of managing board conflicts of interest is through appropriate checks and balances in board composition, not by eliminating market expertise.

Market participants that are subject to the SRO's direct regulatory authority should be represented on the SRO's board. The knowledge and experience these individuals bring to the board are essential to ensure that the board's decisions are economically viable and are feasible from a business standpoint. There are often several ways to address a problem, and market participants are usually the best qualified to determine which method will address the problem most efficiently – providing the necessary protection to customers and other market participants while minimizing the burdens on regulated individuals and entities. Moreover, these market participants should have a voice in how they are regulated; eliminating them harms the self-regulatory process by removing the "self" from "self-regulation."

Not all market participants have the same interests or approach problems alike, however. Market participants regulated by the SRO may fall within different categories due to the nature of their business, and each of these categories should be represented on the board. 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 in the same line of business.

NFA's Board provides one model for this type of structure. Our Board is comprised of representatives from contract markets, FCMs, IBs, CPOs and 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 – and the IB category requires one IB board member to represent guaranteed IBs and the other to represent independent IBs.

The CFTC's governance principle should be general enough to apply to all types of SROs and flexible enough to allow each SRO to adopt the composition that best reflects its structure and the needs of its constituents. We believe that the governing principle should simply state that the SRO should have a diverse board that represents the interests of all of the SRO's constituents, including the public, and incorporates appropriate checks and balances so that no one constituency can dominate the board.

Question 2 – How and by whom should SRO boards be nominated and elected? If directors should represent particular communities, should each community nominate and/or elect its representatives to the board? If the board consists of independent directors, what nomination and election procedures are necessary to ensure independence?

Answer – SRO board members should be selected by the constituencies they represent. NFA has successfully used this structure since its inception, resulting in a diverse board that represents the interests of all Members. Market participants regulated by NFA are nominated by a subcommittee of the nominating committee that represents that particular category or through a petition signed by 50 NFA Members from that category.[2] The Members in that category elect their board representatives from the resulting slate. In other words, only FCMs can nominate and vote for FCM representatives, only IBs can nominate and vote for IB representatives, and only CPOs/CTAs can nominate and vote for CPO/CTA representatives. We strongly believe that this process is part of the checks and balances to ensure a diverse board that represents the interests of all SRO constituencies.

NFA's public directors can be nominated by a single NFA Member, and no Member, director, or officer – or group of Members, directors, or officers – can keep someone off the ballot.[3] NFA solicits public director nominations from all NFA Members. The Executive Committee reviews these nominations and recommends one candidate for each position, but it forwards all of the nominations to the Board. The Board elects the public directors by majority vote at its February meeting. Since NFA's board is not dominated by any one constituency, no constituency can select the public directors on its own. This process helps to ensure the independence of our public directors. Governance principles that ensure a diverse board will go a long way in ensuring that public directors elected by the board are independent of any particular group.

Question 3 – Should SRO boards include independent directors and, if so, what level of representation should they have? What are appropriate definitions of "independent director" and "public director?" Should all independent directors be public directors? Please address whether SRO members can be considered independent. Also, please address whether the New York Stock Exchange's definition of independent – the requirements include independence from the exchange's management, members, and member organizations – is an appropriate model for the futures industry.

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[2] Candidates can also be nominated through a petition submitted by an association that fairly represents that category (e.g., FIA could nominate FCM representatives). This process has never been used.

[3] Any individual timely nominated by one or more Members must be included on the ballot unless the individual does not meet the qualifications for public directors.

Answer – The definition of "independent director" in Article IV, Section 2 of the New York Stock Exchange's Constitution is similar, although not identical, to the futures SROs' definitions of public directors. The NYSE's board composition is not appropriate for futures SROs, however. As noted in response to Question 1, the principal method of managing board conflicts of interest is through appropriate checks and balances in board composition, not by eliminating market participants from the board.

NFA's board has always included 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.[4] While we believe that all SROs should have public directors, one size does not fit all, and who qualifies as a public director should depend on the particular SRO.

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; in NFA's twenty-year history its public representatives 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. Of course, strong Commission oversight should ensure that an SRO's public representatives are appropriately diverse and adequately represent the interests of non-members.

B. Regulatory Structure

As with board composition, the Commission should not mandate a particular regulatory structure. Instead, the Commission should use its oversight role to monitor each SRO's ability to manage conflicts between the SRO's regulatory and business functions and between its interests and those of its members, and the Commission should require the SRO to take corrective action when necessary.

Question 4 – Are the governance standards applicable to listed companies sufficient for futures exchanges or their listed parent companies? Or, given that futures exchanges are not typical corporations in that they bear self-regulatory responsibilities, should they adopt higher governance standards, particularly with respect to self-regulatory activities? Please explain.

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[4] Section 17(a)(11) of the Commodity Exchange Act requires that no less than 20% of the regular voting members of a registered futures association's board be comprised of qualified nonmembers of or persons who are not regulated by the RFA.

Answer – The NYSE's governance standards applicable to listed companies are designed to protect public stockholders from insider transactions that are not in the stockholders' best interests. Since NFA is a not-for-profit, non-stock company, this definition is of limited use in determining who should serve on our board.

Question 5 – Should SRO's regulatory functions be overseen by a body that is internal to the SRO, but independent of management, members, and business functions? If so, what specific functions should fall within its purview (e.g., regulatory budget; personnel decisions; compensation of regulatory staff; compliance and disciplinary programs; other aspects of self-regulation)?

Answer – Recently, a number of exchanges have set up independent committees to oversee SRO regulatory functions in order to insulate their regulatory functions from their market functions. While an independent committee is one way to manage conflicts between the two functions, it is not the only way to do so and is not an efficient solution for all 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 and therefore have initiated an annual report to our board on our regulatory activities.

Question 6 – Please address whether any rule enforcement, disciplinary, or other functions currently performed by exchanges should be performed instead by an independent regulatory services provider.

Answer – The Commission should not mandate that certain regulatory functions be performed by an independent body. Exchanges should have the option to outsource some or all of their regulatory functions, however.

Self-regulation is a proven commodity that has played a vital role in the futures industry over the years. Currently, the industry is in a period of profound change, which has heightened conflicts of interest in the SRO process. Undoubtedly, the SRO process will have to continue to evolve in response to these industry changes and the Commission will have to vigilantly oversee this evolution.

As we previously noted, there are three ways to manage conflicts of interest in the self-regulatory process. Allocating responsibilities between SROs is one way – and only one way – of managing those conflicts. The Commission should continue to work closely and play a leading role with all futures SROs to ensure that the alignment of regulatory responsibilities is consistent with the public interest, but the Commission should not dictate how those responsibilities are allocated. Eliminating the SROs' role in allocating self-regulatory responsibilities is a contradiction in terms.

D. Disciplinary Committees

While SRO rules must be fair and potential conflicts must be managed in SRO disciplinary matters, the Commission is the ultimate insurer of integrity in the disciplinary process. Vigilant government oversight – through the appellate process and vigorous rule enforcement reviews – is the key to insuring that integrity.

Questions 9 and 10 – How should SRO disciplinary committees be structured so as to ensure both expertise and impartiality?

Please address whether SRO disciplinary committees should have independent, non-SRO member chairs and/or committee membership. Should the level of representation for independent, non-SRO members vary according to the type of disciplinary case?

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 each hearing panel that considers an action against a board or disciplinary committee member. Although this is all NFA's rules currently require, we make much greater use of non-members in practice.[5] Using non-members as part of the disciplinary process has two advantages: it enlarges the pool of qualified individuals from which we can draw, and it enhances the perception of fairness.[6]

Disciplinary committees and hearing panels should not require a majority of non-members or a non-member chairperson, however. Diverse disciplinary committees and hearing panels and appropriate limitations on a chairperson's authority to act alone provide all the checks and balances that are needed.[7]

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[5] The Board adopted rule amendments in August that would codify this practice. Those amendments are currently pending Commission approval.

[6] Disciplinary panels made up entirely of members can also be fair, but they are not always viewed that way. Adding non-members to the process increases confidence in an already fair process.

[7] For example, the chairperson of an NFA hearing panel can decide procedural motions, but motions that are outcome-determinative must be decided by the full panel.

The credibility of the disciplinary process can also be enhanced by ensuring that the SRO has sound internal procedures to ensure that enforcement staff does not have undue influence on adjudicatory decisions. For example, the attorneys who act as counsel to NFA hearing panels do not prosecute cases and, except for status inquiries, do not discuss individual cases with the enforcement staff.[8]

Question 11 – How and by whom should SRO disciplinary committees be appointed? Should the terms of committee members be limited? Please explain.

Answer – Disciplinary appointments should be subject to appropriate controls. A board that is properly structured and diverse, so that no one constituency controls the outcome of any board action, should be able to appoint disciplinary committees without raising conflict of interest concerns. When cases are heard by hearing panels composed of a subset of committee members appointed by the board, staff should be allowed to appoint the panelists as long as the SRO has sound internal procedures to ensure that enforcement staff does not have any influence on who is appointed. The goal is to provide appropriate checks and balances to mitigate any potential conflicts.

E. Other Issues

Question 12 – What additional information, if any, should SROs make available to the public to increase transparency with respect to their governance and regulatory structures (*e.g.,* board member affiliations; regulatory staffing and budget; disciplinary committee membership and affiliations, etc.)?

Answer – The SRO process must be transparent to ensure its credibility. 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 placed on the website where it is accessible to the public. Rule submissions are also posted on NFA's website, as is the entire rulebook.

Information on NFA disciplinary proceedings is also readily available to Members and the public. Notice of decisions issued in disciplinary and membership cases and of membership responsibility actions taken by the Executive Committee is posted on our website with a link to our BASIC system, and adjudicated, default, and

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[8] At NFA, the panel's counsel is the conduit between the panel and the parties, advises the panel on procedural matters, and drafts the decision as the panel directs. The panel's counsel does not comment or provide advice on the merits of the case.

appeals decisions are posted in full. Pending charges are also included in BASIC, and all pleadings are available to the public upon request.[9]

Question 14 – What steps should be taken to manage or eliminate conflicts of interest involving SRO board and disciplinary committee members?

Answer – As we previously noted, boards and disciplinary committees should be diverse so that no one constituency is able to dominate the board or the disciplinary process. The Commission must work with the SROs to ensure a proper allocation of regulatory responsibilities, and the Commission must provide strong government oversight. All three of these components are essential in order to manage SRO conflicts of interest.[10]

Beyond these overarching principles, there are a number of steps that SROs can take to manage the conflicts inherent in the process. All SROs should adopt a conflicts policy requiring full disclosure of any potential conflicts and a method for addressing those conflicts. Moreover, board members should receive annual training to ensure that they will be able to identify relationships and affiliations that might be viewed as raising a conflict. Finally, all board members should be required to update and disclose their affiliations at least once a year.

Question 15 – Should registered futures associations that are functioning as SROs also be subject to governance standards?

Answer – As we stated at the outset of this letter, registered futures associations should be subject to the same governance standards as other SROs. NFA faces different challenges than SROs that operate a market, however, and the standards should be flexible enough to account for these differences.

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[9] We post new default, adjudicated, and appeals decisions on a special section of our website when they are issued, and we are in the process of adding older decisions to that section. We are also making enhancements to BASIC and will be adding all significant pleadings (e.g., complaints and answers) and decisions, including settlement decisions, to BASIC going forward.

[10] We do not believe that conflicts of interest can, or even should, be eliminated entirely. Market participants subject to an SRO's direct regulatory authority must have a voice on the board and in the disciplinary process in order to provide expertise and ensure the fairness of board and disciplinary actions.

Once again, NFA commends the Commission for undertaking this review of the governance of SROs. NFA appreciates the opportunity to comment on these important questions. If Commission staff would like to further discuss these or any other governance 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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