

**Performance Audit:  
U.S. Commodity  
Futures Trading  
Commission's  
Oversight of the  
National Futures  
Association**

**Office of the Inspector General  
May 31, 2017**





## U.S. COMMODITY FUTURES TRADING COMMISSION

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**DATE:** May 31, 2017

**SUBJECT:** Performance Audit: U.S. Commodity Futures Trading Commission  
Oversight of the National Futures Association

### Introduction

The Commodity Futures Trading Commission (CFTC or Commission)<sup>1</sup> Office of Inspector General (OIG)<sup>2</sup> has completed a performance audit of CFTC's oversight of the National Futures Association (NFA). NFA is the sole registered futures association (RFA) under the Commodity Exchange Act (CEA), and is the designated self-regulatory organization (DSRO) for all Swap Dealers (SD) and some Futures Commission Merchants (FCMs).<sup>3</sup> The CFTC Division of Swap Dealer and Intermediary Oversight (DSIO) is the CFTC component charged with oversight of NFA and its duties. DSIO's Registration and Compliance Branch and Examination Branch perform the bulk of NFA oversight.<sup>4</sup> Because the current Director of DSIO started with CFTC in August 2015,<sup>5</sup> and the Deputy Director for the Examinations Section began with CFTC in June 2016, we believe this audit may assist new leadership to make program improvements.

DSIO identified eight program areas where NFA has responsibility by statute or delegation: 1) registration of all categories of Commission registrants and the examination of FCMs and SDs; 2) Commodity Pool Operator (CPO)/Commodity Trading Advisor (CTA) special provisions; 3) foreign futures and options special provisions; 4) financial surveillance program; 5) arbitration program; 6) sales practices; 7) telemarketing supervision; and 8) other.

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<sup>1</sup> CFTC is the primary federal regulator for futures markets, including futures exchanges and intermediaries including Futures Commission Merchants, Retail Foreign Exchange Dealers, Commodity Pool Operators, Commodity Trading Advisors, Introducing Brokers, Floor Brokers, Floor Traders, Leverage Transactions Merchants, Associated Persons, and since passage of the Dodd-Frank Act two new categories, Swap Dealers and Major Swap Participants.

<sup>2</sup> CFTC OIG is described in its Semiannual Report to Congress, September 30, 2016.

<sup>3</sup> Background information on NFA may be found at [Appendix C](#). Definitions of terms such as FCM and DSRO are found at [Appendix E](#).

<sup>4</sup> The relevant DSIO sub-organizations are displayed at [Appendix D](#).

<sup>5</sup> [CFTC Chairman Massad Announces the Appointment of Eileen T. Flaherty as Director of the Division of Swap Dealer and Intermediary Oversight](#), July 24, 2015.

For Calendar Year (CY) 2012 through CY 2016, we evaluated DSIO's oversight of the eight program areas. DSIO's oversight consists of daily interactions with NFA, quarterly meetings, consultation and approvals for examinations; processing of NFA rules and rule amendments; written reviews or reports of NFA operations; and follow-up of recommendations. Finally, we evaluated CFTC staffing levels and the extent to which CFTC is able to leverage NFA's staff.

## Summary Findings

Daily interactions and quarterly meetings. In fulfilling oversight responsibilities, DSIO displayed a high degree of daily collaboration with NFA regarding registration and regulatory issues. Daily collaboration permits DSIO and NFA to address technical and compliance issues timely and with minimal bureaucracy. DSIO's quarterly meetings with NFA management permit DSIO to address technical and compliance issues in similar fashion.

FCM and SD examinations. While DSIO's oversight of NFA's FCM examinations appears adequate, CFTC has not finalized Swap Dealer exam criteria for financial requirements because the Commission has not yet adopted capital requirements and NFA therefore has not performed Swap Dealer financial examinations. NFA examinations are an essential part of its delegated registration authority given the significant size of the cleared swap market; a weekly average of \$4.6 trillion during January 2017.<sup>6</sup> In addition, NFA examinations tie directly to CFTC's objective of "strong governance and oversight of Commission registrants."<sup>7</sup>

Written reviews or reports. For four of eight NFA program areas, DSIO could not show that it performed written reviews periodically.<sup>8</sup> As such, DSIO cannot demonstrate how well NFA performs delegated tasks related to the Arbitration Program, CPO/CTA special provisions, Foreign Futures and Options (Part 30) programs, and the tasks falling in the catch-all category "other" (which includes NFA disciplinary proceedings and anti-money laundering programs).

For the written reviews conducted, DSIO does not rigorously follow government audit or other recognized quality standards;<sup>9</sup> however, we identified no requirement that it do

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<sup>6</sup> Source: Transaction Dollar Volume by Cleared Status (Millions of USD) (Single-Count). <http://www.cftc.gov/MarketReports/SwapsReports/L1TransDollarVolCS>

<sup>7</sup> CFTC, [Strategic Plan for Fiscal Year 2014-2018](#), p. 21.

<sup>8</sup> CFTC has stated that it "will continue to monitor NFA activities through periodic rule enforcement reviews." 17 CFR Part 3 Appx A.

<sup>9</sup> CFTC has stated that some staff reviews are not performed in accord with audit standards. See Proposed Rule, Commodity Futures Trading Commission, 17 CFR Parts 1, 3, 22 et al., 77 FR 67866, \*67868 (Nov. 14, 2012); [Testimony of Gary Gensler](#), Chairman, CFTC, before the U.S. Senate Committee on Agriculture, Nutrition and Forestry, Washington, DC (Aug. 1, 2012).

so.<sup>10</sup> Consistently following quality standards would permit DSIO to uniformly report NFA's performance over time and facilitate recommendation follow-up.

With regard to reporting, we found no evidence that DSIO's reports were distributed to the Commission or made public. Six of ten written reviews were not distributed to NFA in final; the other four were distributed to NFA in final after the arrival of the current DSIO Director. Always providing final written reviews to NFA would permit DSIO to better communicate and prioritize findings and recommendations, to better document NFA's receipt of findings and recommendations, and would permit NFA to commit to corrective actions. While the Commission may obtain any DSIO report, we believe furnishing the Commission with final written reviews of NFA would be the better practice.

Follow-up of recommendations. Since August 2015, DSIO has closed out recommendations in four written reviews under the scope of our audit (i.e., the ones that were given to NFA). However, NFA expressed concerns regarding recommendations contained in two of the four reviews. It appears there was confusion, possibly on both sides, as to what was intended. We will be taking a look at this in the next year. We hope CFTC will be precise in any advice given, and NFA will respond precisely to any suggestions CFTC may have.

As for the rest of the reports prior to August 2015, DSIO discussed recommendations with NFA on an ongoing basis but did not formally track or otherwise document the follow-up process through recommendation closeout. DSIO does not preserve a status log of recommendations made to NFA.

The impact of NFA's efforts on CFTC staffing levels. Finally, we learned that NFA's services are essential for performing tasks beyond the CFTC's and DSIO's resources, and therefore the agency leverages NFA staff to a great extent to perform its regulatory oversight of registrants. NFA is funded through member fees and assessments. NFA pays for CFTC's oversight services; the fee is remitted to the U.S. Treasury. Nevertheless, we believe NFA should evaluate whether it may be able to obtain audit and review services more cheaply.

[Appendix A](#) provides further details of the results of our audit.

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<sup>10</sup> In contrast, our 2015 [Performance Audit of the Division of Market Oversight's Rule Enforcement Review](#), noted "the Market Compliance Branch staff utilized a checklist for each RER conducted. This checklist is structured into five (5) sections and includes a listing of standard questions and procedures that must be asked and/or performed by the Market Compliance Branch staff."

## Recommendations

We recommend the Director of DSIO:

1. Approve a plan for NFA to examine Swap Dealer members for financial requirements after the Commission adopts financial capital rules.
2. Adopt written standards for reviews of NFA, including a periodic schedule for completion.
3. Evaluate NFA's performance of delegated tasks related to the Arbitration Program, CPO/CTA special provisions, Foreign Futures and Options, and "other," or:

Following a study of costs, require NFA to submit its eight program areas to engagements (as scheduled) by an independent public accountant (IPA) or other suitable entity whenever it would be cost-effective for the NFA or for CFTC.

4. Furnish all final written reviews and audits to NFA and to the Commission and revisit disclosure policies.
5. Establish a system for tracking status and closing recommendations.

## Management Comments

Management generally concurred with the recommendations, has taken corrective action(s), or plans to take corrective action(s). Management also detailed their perspectives for each finding. See [Appendix F](#) for management comments in its entirety.

With respect to recommendation 1, DSIO will work with NFA to develop an examination program for assessing swap dealers' compliance with relevant capital requirements once the Commission adopts final capital rules for swap dealers. They also detailed ongoing oversight activities in the interim.

With respect to recommendation 2, DSIO agrees that its examinations of NFA program areas should follow written standards but details its disagreement with any assertion that it currently does not follow written standards in conducting oversight examinations of NFA. DSIO understands that the recommendation is directed to the written reports that are prepared as part of its NFA oversight examinations. DSIO also understands that the impetus for the recommendation is the OIG's belief that a more fulsome discussion of the methodology and standards of the examination should be included in future written reports. DSIO has no objection to providing additional details on these points in future written examination reports.

With respect to the recommendation that the Division maintain a written schedule of the completion of examinations, DSIO established a three year written schedule of examinations. This three-year schedule was established in March 2016 at the request of

current Division management, independent of this Performance Audit, and a copy has been provided to OIG staff.

With respect to recommendation 3, DSIO agrees that there should be a formal schedule for the oversight of NFA SRO programs and/or delegated responsibilities. In this connection, DSIO as previously stated maintains a three-year examination schedule of NFA financial and non-financial program areas. The current schedule lists examinations that are to be performed during the fiscal years ending September 30, 2017 through 2019. DSIO believes that the frequency of DSIO examinations of NFA program areas should be risk-based, with greater emphasis on and frequency of examinations of NFA program areas that, if not effectively performed, pose a greater risk to customers, market participants, and/or the financial system as a whole.

However, DSIO does not agree to submit its eight program areas to engagements by an independent public accountant. DSIO opines that outsourcing of the Commission's direct oversight of NFA's performance of its statutory, regulatory and delegated responsibilities to a third-party independent public accountant is inconsistent with Section 3 of the Commodity Exchange Act. Further, DSIO has significant doubts as to whether independent public accounts can adequately assess NFA's oversight programs for compliance with the Act, Commission regulations, and NFA rules and interpretations, particularly at a substantial savings over the fees assessed by the Commission.

With respect to recommendation 4, regarding disclosure of NFA reports, DSIO agrees with the recommendation, states that the decision for the current policy stemmed from a previous administration, and intends to elevate this issue to the Commission for its consideration.

Lastly, with respect to recommendation 5, DSIO agrees that a centralized recommendations log for financial and non-financial examinations is appropriate, and this recommendation has been implemented.

## **Evaluation of Management Comments**

Management's corrective actions planned or implemented are generally responsive to the findings and recommendations. As it pertains to following quality standards for its reviews, we focused on reporting and follow-up procedures. DSIO's stance that it "does generally incorporate similar procedures and requirements as are included in such standards" ignores the fact that neither GAGAS nor AICPA standards allow for partial adoption, and that both provide for accountability through peer reviews to ascertain compliance. We believe that as an independent agency, when conducting "reviews" or "examinations" CFTC should follow and communicate in written products a recognized standard of work with established accountabilities for quality, or at the least should create standards applicable to all NFA examinations and communicate them to NFA. In reference to outsourcing reviews to independent IPAs, we believe DSIO would benefit professionally from a pilot project in collaboration with the NFA. The outcome should

show whether certain examinations are better left to the private sector as desired by the President in his executive order<sup>11</sup> for reorganizing the executive branch.

We conducted this performance audit in accordance with *Generally Accepted Government Auditing Standards*. [Appendix B](#) provides the objective, scope, and methodology for our audit. We will publish this report on the Office of the Inspector General's web page and the report will be summarized in our September 30, 2017, *Semiannual Report to Congress*. If you have any questions, please contact me at (202) 418-5084 or Tony Baptiste, lead analyst, at (202) 418-5115.

**Cc:** Michael Gill, Chief of Staff  
Daniel Davis, General Counsel  
Anthony Thompson, Executive Director  
Melissa Jurgens, Chief, Executive Secretariat Branch  
A. Roy Lavik, Inspector General  
Judith Ringle, Deputy Inspector General and Chief Counsel

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<sup>11</sup> [Presidential Executive Order on a Comprehensive Plan for Reorganizing the Executive Branch](#), March 13, 2017.

## **Appendix A – Detailed Findings**

### **DSIO Collaborates with NFA for Registration Activities**

To confirm our understanding of collaboration between NFA and DSIO, we viewed weekly and quarterly meetings with NFA counterparts to address open registration and regulatory matters, and watched an Associate Director for registration matters discussing registration exceptions with staff at NFA.<sup>12</sup> Independent queries of a computer database and reports used by DSIO and NFA staff further confirmed NFA's responsiveness to DSIO oversight inquiries.

We noted that NFA and DSIO closely collaborated on procedures for evaluating registration applications. Specifically, we reviewed documents DSIO exchanged with NFA for conducting their review of potential registrants. These documents showed active dialogue with NFA to address policies and procedures and to refine criteria for NFA to effectively assess applications. As an example, we noted DSIO's registration staff along with NFA's staff forged a common analytical framework to ensure regulatory harmonization for Swap Dealer registrations.

### **DSIO Collaborates with NFA for Examinations of FCMs but Swap Dealer Financial Examinations are not Conducted**

In its role as a DSRO, NFA is required to prepare examination plans of FCMs for DSIO approval that, at a minimum, conform to Joint Audit Committee standards.<sup>13</sup> After that, NFA conducts examinations and directs results to DSIO. We attended quarterly meetings and observed DSIO staff discussing proposed examinations and open issues with NFA staff. These observations show an effective working relationship between NFA and DSIO staff for risk-based exams of FCMs.

We observed that the DSIO Deputy Director and Regional Associate Directors in the Examinations Branch are aware of daily financial compliance information filed by FCMs with NFA. NFA shares this information with DSIO through a common database.<sup>14</sup>

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<sup>12</sup> In a 2007 report, the U.S. Government Accountability Office (GAO) stated with regard to CFTC's verbal interactions with large traders, "actions taken by CFTC staff to inquire about potential problems may not always be documented," and that, "[w]ithout such data, CFTC's measures of the effectiveness of its actions to combat fraud and manipulation in the markets will not reflect this surveillance activity, and CFTC management might miss opportunities to both identify trends in activities or markets and better target its limited resources." GAO, Trends in Energy Derivatives Markets Raise Questions about CFTC's Oversight, [GAO-08-25](#) (Oct. 19, 2007). We are not prepared to recommend documenting each interaction with NFA at this time because, in contrast to interactions with traders, interactions with NFA generally do not raise the same regulatory interests.

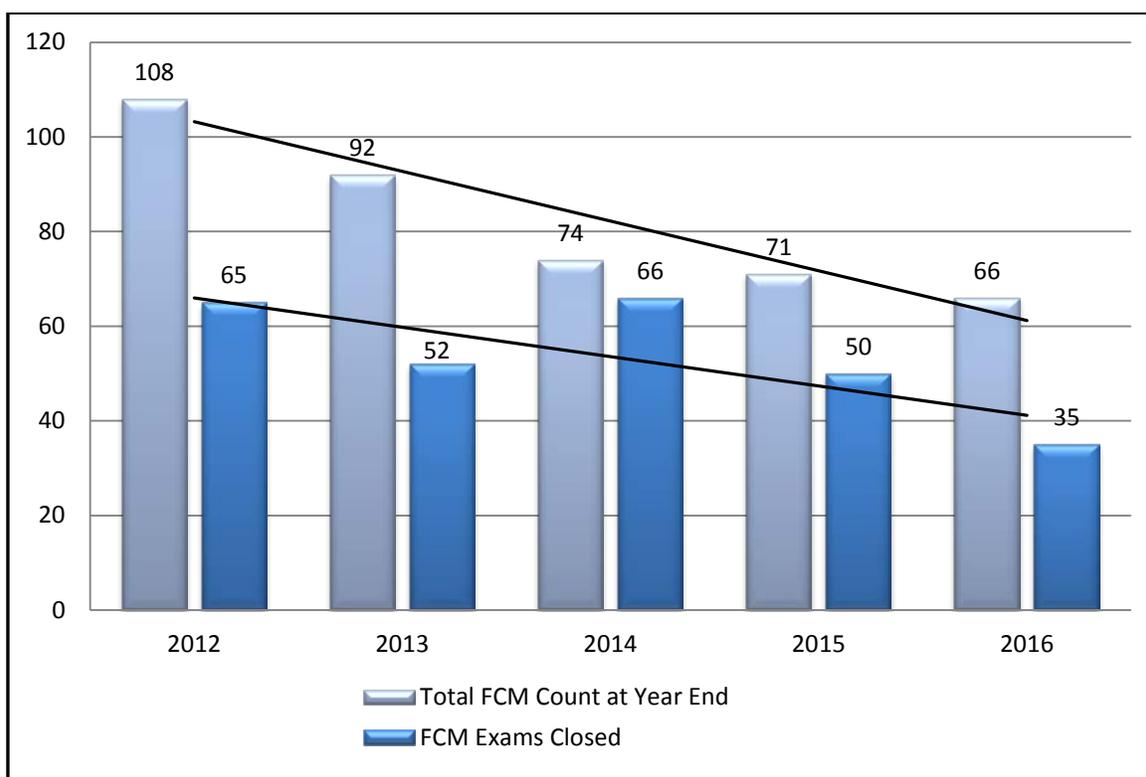
<sup>13</sup> The Joint Audit Committee is a cooperative organization comprised of representatives of US futures exchanges and regulatory organizations. Among other things, it determines the practices and procedures to be followed by each DSRO in the conduct of audits and financial reviews of FCMs. For a full list of the Committee's members and to learn more about the Committee, visit the [JAC website](#).

<sup>14</sup> Financial Analysis & Audit Compliance Tracking System. See CFTC, [Privacy Impact Assessment for NFA Applications Suite System](#), Sept. 30, 2016, for more information.

DSIO staff told the review team that NFA is responsible for database content; we did not verify the accuracy of the database. DSIO staff uses the common database to verify that NFA monitors the FCMs for which it is the DSRO.

With regard to financial compliance by intermediaries, DSIO's oversight activities do not end with monitoring NFA and other SROs and DSROs. In addition, DSIO undertakes exams of intermediaries that are regulation specific. In conducting these examinations, DSIO relies on financial audit reports produced by independent CPA firms, examinations undertaken by NFA to fulfill its oversight role, and targeted examinations by DSIO to fulfill its oversight role.<sup>15</sup>

Since DSIO monitors NFA's completed FCM examinations, we evaluated the volume of FCM examinations completed. Figure 1 illustrates the number of examinations performed including by NFA since CY 2012. As of December 31, 2016, it appears the trend of closed exams corresponds with a required 15 to 18-month cycle.<sup>16</sup>



**Figure 1. FCM Examinations Completed as Compared to all FCMs.**

<sup>15</sup> For more information see CFTC, Proposed Rule, 17 CFR Parts 1, 3, 22 et al., 77 FR 76866, \*76868 (Nov. 14, 2012).

<sup>16</sup> 17 CFR 1.52(c)(1)(iv)(A).

For Swap Dealers, neither the Commission nor the NFA had conducted examinations of the 104 SDs provisionally registered at the time of our audit. NFA’s application reviews started in 2012 after the Commission delegated to NFA responsibility for managing swap entity registrations and withdrawals. However, the Commission’s implementation regulations is not complete. Therefore, NFA has not started examinations of provisionally registered Swap Dealers for financial requirements as the Commission has not yet adopted final capital rules.

**DSIO Reviews Are Lacking for Some Program Areas**

DSIO’s Major Review Section (MRS) staff, including senior auditors, conducts periodic program reviews of NFA’s delivery of delegated tasks.

While DSIO has not fixed a review frequency for each program area, Commission regulation 1.52(c)(2)(iv) states, “a self-regulatory organization must cause an examinations expert to evaluate the supervisory program and such self-regulatory organization’s application of the supervisory program *at least once every three years.*” Therefore, as a benchmark, we applied a three-year period to evaluate DSIO’s completion of reviews (see Table 1). DSIO reviews NFA’s financial surveillance program roughly every six months, has reviewed NFA’s registration program within the past three years, and completed reviews of two other program areas after the close of cut-off date for our fieldwork (see Table 2); however, for 4 of 8 program areas DSIO has not completed a written review within the past three years. Thus, DSIO cannot demonstrate how well NFA performs delegated tasks related to the Arbitration Program, CPO/CTA special provisions, Foreign Futures and Options (Part 30) programs, and the tasks falling in the catch-all category “other.”

We realize DSIO may believe three years is not the optimal timeframe to assess NFA performance in each of the eight program areas. We encourage DSIO to document procedures for determining timeframes for formal review of NFA program areas.

**Table 1. Reviews of NFA Major Program Areas**

	<b>Oversight Program Area</b>	<b>Description</b>	<b>Year of Last Review</b>
1	Registration Program (including examinations)	NFA is responsible for registering members, including swap dealers (SDs) and futures commission merchants (FCMs). <sup>17</sup>	2016 (and Collaborative)
2	Commodity Pool Operators (CPO)/ Commodity Trading Advisors (CTA) Special Provisions	Conduct reviews of disclosure documents filed by CPOs (for privately offered pools) and CTAs. <sup>18</sup>	Collaborative

<sup>17</sup> A detailed description of NFA may be found at Appendix C.

<sup>18</sup> 17 CFR 4.26(d), 4.36(d).

	<b>Oversight Program Area</b>	<b>Description</b>	<b>Year of Last Review</b>
3	Foreign Futures and Options (Part 30) Special Provisions	Perform fitness checks with respect to foreign firms. <sup>19</sup>	No report on record. DSIO indicated that reviews of sales practices are encompassed in the reviews of the disciplinary process.
4	Financial Surveillance Program	Review commodity pool annual financial reports. <sup>20</sup>	9 reports since 2012
5	Arbitration Program	Rules provide a fair, equitable, and expeditious procedure through arbitration or otherwise for the settlement of customers' claims and grievances against any member or employee. <sup>21</sup>	None since 2008
6	Sales Practices	Establish training standards and proficiency testing for persons involved in the solicitation of transactions, their supervisors and a program to audit and enforce compliance with such standards. <sup>22</sup>	No report on record during the scope of our audit. DSIO finalized a report to NFA April 2017.
7	Telemarketing Supervision	Establish special supervisory guidelines to protect the public interest relating to the solicitation by telephone of new futures or options accounts. <sup>23</sup>	No report on record during the scope of our audit. DSIO finalized a report to NFA April 2017.
8	Other	Design rules to prevent fraudulent and manipulative acts and practices, to promote just and equitable principles of trade, in general, to protect the public interest and remove impediments to and perfect the mechanism of free and open futures trading (includes disciplinary processes and anti-money laundering programs). <sup>24</sup>	Collaborative

Because we received a hotline complaint, we took an interest in the NFA arbitration and disciplinary programs. NFA arbitrations are not appealable to the Commission or to federal or state courts. As NFA does not publish its arbitration decisions, it is apparent that NFA arbitration decisions are not subject to evaluation and comment by other

<sup>19</sup> 17 CFR 30.5, 30.10, and Part 30 Appx. A

<sup>20</sup> 17 CFR 4.7(b)(3), 4.22(c).

<sup>21</sup> All RFAs are required to maintain an Arbitration Program, or another such method, for the settlement of customers' claims or grievances against any member or employee of an RFA. 7 USC 21(b) (10), 17 CFR 170.8.

<sup>22</sup> 7 USC 21(p)(1).

<sup>23</sup> 7 USC 21(p)(4).

<sup>24</sup> 7 USC 21(b)(7).

entities, the press, etc. We are therefore especially sensitive to the need for periodic oversight of NFA’s arbitration program, in order to ensure that arbitrators are qualified and unbiased, and that complaining customers, as well as NFA members (and their employees), receive all due process required.

In contrast to arbitration proceedings, NFA disciplinary proceedings<sup>25</sup> may be appealed to the full Commission,<sup>26</sup> and thereafter to the federal courts.<sup>27</sup> Nevertheless, CFTC oversight is necessary in order to assure, among other things, that NFA is not neglecting to bring disciplinary actions when warranted. CFTC last reported on NFA’s disciplinary function (which falls under the catch-all category “other”) in 2002.<sup>28</sup>

DSIO demonstrated ongoing collaboration with NFA with regard to registration and regulatory matters, CPO/CTA special provisions, and tasks falling in the catch-all category “other.” We have no recommendations to improve the collaboration demonstrated by DSIO with regard to these various functions, but believe that these functions should also be subject to periodic reviews at documented intervals. We note that DSIO also demonstrated ongoing collaboration with NFA relating to registration and examinations, and completed its most recent review of the registration function in 2016.

#### DSIO’s NFA Reports are Documented but Lack Established Standards

There is no requirement for DSIO to follow formal audit standards in the creation of its reports. CFTC has publicly reported that some reviews are not performed in accord with audit standards.<sup>29</sup> Based on our fieldwork, we are satisfied that DSIO generally documents its work for its written reviews.<sup>30</sup> Nevertheless, we believe adopting written quality standards, especially with regard to reporting and recommendation follow-up, would improve its oversight of NFA as discussed in the next sections.

#### DSIO Has Not Reported All Reviews to NFA or the Commission; DSIO’s NFA Reviews are not Published to the CFTC Website

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<sup>25</sup> NFA’s enforcement and registration actions are available here:

<http://www.nfa.futures.org/news/newsActionsList.asp>.

<sup>26</sup> 7 USC 21(h); 17 CFR Part 171. In addition, the Commission may institute review of disciplinary actions taken by a RFA on its own motion. 17 USC 21(h)(3).

<sup>27</sup> 7 USC 21(i)(4).

<sup>28</sup> CFTC, Division of Clearing and Intermediary Oversight, [Review of the Disciplinary Program of National Futures Association](#), July 2002.

<sup>29</sup> In our 2013 report, Review of the Commodity Futures Trading Commission’s Regulation and Oversight of [MF Global](#), we noted that the DSIO examinations branch did not follow audit standards with respect to its reviews of FCMs (including MF Global) and opined: “The reports created by the Examinations Branch did not conform to audit standards, and it does not appear that the Examinations Branches were subject to peer reviews or other detailed internal examination. This does not *ipso facto* mean that the Examinations Branch performed poorly.”

<sup>30</sup> See fn.8.

DSIO's written reviews are not always provided to NFA or to the Commission. Reviews are sometimes communicated to NFA and separately to the Commission in meetings or in-person presentations. Table 2 shows the reports we reviewed and their distribution.

**Table 2. Reports Distribution**

	<b>Program Area</b>	<b>Title</b>	<b>Date</b>	<b>Report Distribution</b>
1	Financial Surveillance	Review of the Examinations, Processing of Financial Statements, Staffing, and Regulatory Notices Components of the National Futures Association's Unit and Financial Surveillance Program	Feb-12	NFA -Draft
2	Financial Surveillance	National Futures Association Quarterly Review	Jun-12	NFA - Files
3	Financial Surveillance	DSIO's Review of the National Futures Association's Evaluation of Member Firm Internal Controls and Risk Assessment Policies and Procedures	Feb-13	NFA - Files
4	Financial Surveillance	Review of the Examinations, Financial Statement Processing, Notice Processing, and Various Other Components of the National Futures Association's Audit and Financial Surveillance Program	Feb-14	NFA -Draft
5	Financial Surveillance	Review of the National Futures Association's Financial Surveillance Program	Oct-14	NFA - Draft
6	Financial Surveillance	Review of the National Futures Association's Financial Surveillance Program	Apr-15	NFA -Draft
7	Financial Surveillance	Review of the National Futures Association's Financial and Compliance Surveillance Program	Nov-15	NFA - Final
8	Financial Surveillance	Review of the National Futures Association's Financial and Compliance Surveillance Program	May-16	NFA - Final
9	Financial Surveillance	Review of the National Futures Association's Financial and Compliance Surveillance Program	Aug-16	NFA - Final
10	Registration	Review of the National Futures Association's Financial and Compliance Surveillance Program Swap Dealer/Major Swap Participant 4s Registration/Application Review	Nov-16	NFA - Final

DSIO provided no evidence that six of ten written reports we reviewed were provided to NFA. None were addressed to the Commission as final reports. The four final reports transmitted to NFA occurred after the current DSIO Director was appointed. Providing final reports to NFA would permit DSIO to better document NFA's receipt of findings and recommendations, and would permit NFA to commit to corrective actions.<sup>31</sup> While the Commission may obtain any DSIO report, we believe also furnishing the Commission with final written reviews of NFA would be the better practice.

<sup>31</sup> See [GAO-12-331G](#) *Government Auditing Standards*, 2011 Revision, Section 5.52. ("Audit organizations in government entities should distribute reports to those charged with governance, to the appropriate audited entity officials, and to the appropriate oversight bodies or organizations requiring or arranging for the engagements. As appropriate, auditors should also distribute copies of the reports to other officials who have legal oversight authority, and to others authorized to receive such reports.")

CFTC is inconsistent with its disclosure policies for written reports. DSIO's final written reviews are not published to the CFTC website. However, in our 2015 audit, "[Performance Audit of the Division of Market Oversight's Rule Enforcement Reviews](#)," we noted that [final] reports were made public through the CFTC website. CFTC may wish to formalize disclosure policy for its reports on Designated Contract Markets, SROs, RFAs, and others.<sup>32</sup>

### DSIO Does Not Maintain a Log of NFA Recommendations

DSIO management does not maintain a log of recommendations documenting that recommendations have been addressed prior to close out. As previously stated, DSIO provided OIG copies of ten reviews of NFA's performance since 2012. The ten reviews contained 49 recommendations (see Table 3). The majority of recommendations issued by MRS consisted of matters involving NFA examination procedures.

The six oldest reports were not given to NFA. DSIO staff indicated that due to the close working relationship with NFA, recommendations in those six reports were likely discussed. The four most recent reports were given to NFA; those reports contained 11 of the 49 recommendations. DSIO closed the recommendations for the four recent reports even though NFA conveyed difficulty in identifying specific instances that support DSIO's recommendations in 2 of 4 reports. Thus, we plan to follow up on DSIO's recommendation close out procedures in a subsequent review.

The lack of documented recommendation tracking and close out potentially reduces the significance of review findings and corrective action. In addition, recommendations may not receive attention from those charged with governance at NFA. Best auditing practices anticipate that auditors will follow up on recommendations so as to ensure that management is aware of risks of inaction.<sup>33</sup> As a benchmark, *Generally Accepted Government Auditing Standards* (Rev. 2011)<sup>34</sup> require that auditors follow up on known material [significant] findings and recommendations from previous audits that could affect an audit. Due to the Commission's statutory partnership with NFA, it is vitally important that DSIO's MRS recommendations are addressed so as to continuously improve oversight of the commodity and swaps derivatives industry.

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<sup>32</sup> Exemption (b)(8) of the Freedom of Information Act permits an Agency to withhold from disclosure information "contained in or related to examination, operating, or condition reports prepared by, on behalf of, or for the use of an agency responsible for the regulation or supervision of financial institutions." 5 USC 552(b)(8).

<sup>33</sup> See the following relevant guidance: *AICPA General Standards Rule regarding Due Professional Care* for private/public entities and OMB Circular A-50 *Audit Follow up Revised* for government related entities.

<sup>34</sup> See GAO-12-331G *Government Auditing Standards*, 2011 Revision, Section 7.05 *Reporting Standards for Performance Audits* ("The purpose of audit reports are to . . . facilitate follow-up to determine whether appropriate corrective actions have been taken").

**Table 3. DSIO Recommendations to NFA Summarized by Type**

<b>Recommendation Type</b>	<b>Count of Recommendations</b>
Examination Program Execution	34
Financial Statement Processing/Reporting	6
Program Design	3
Regulatory Notice	3
Other	3
Grand Total	49

DSIO Leverages NFA Staff

DSIO, with limited resources and renewed leadership, relies on the NFA for registrant oversight and other delegated responsibilities.<sup>35</sup> NFA states that, in FY 2016, it increased budget and staffing for swaps regulatory programs by close to 20%. This increase resulted in an average NFA headcount of 100, which exceeds DSIO’s allocated staff. DSIO collaborates and will continue to leverage this additional resource for performing registration, compliance and examination tasks.

Between fiscal year 2012 and 2015, DSIO’s employee count increased by 26%, while NFA staff increased by 64%. Overall, the CFTC staff grew by 4% for the same time period. Although industry supervision employs electronic tools as well as human expertise, growth in NFA staff fills a regulatory need not addressed by the growth in DSIO employees. In examining DSIO staffing totals we found that during FY 2015 the examination branch accounted for 47 FTEs out of 91 FTEs assigned to the division. During the same period, another 19 FTEs were assigned to the registration and compliance branch. See Table 4.

NFA is privately funded by fees and annual assessments levied on members for its operations including regulatory services, at no cost to the taxpayer. Therefore, NFA is a cost-effective means for the Commission to accomplish its oversight responsibilities and reinforces the stated Congressional goal of setting up the Commission as an oversight regulator.<sup>36</sup>

<sup>35</sup> CFTC relies on NFA because, “[i]n 2000, Congress affirmed the Commission’s reliance on SROs by amending section 3 of the Commodity Exchange Act to state: ‘It is the purpose of this Act to serve the public interests through a system of effective self-regulation of trading facilities, clearing systems, market participants and market professionals under the oversight of the Commission.’” Proposed Rule, Commodity Futures Trading Commission, 17 CFR Parts 1, 3, 22 et al., 77 FR 67866, \*67868 (Nov. 14, 2012) (referring to the Commodity Futures Modernization Act of 2000, Sec. 108, P.L. 106-554, 114 STAT. 2000 (Dec. 21, 2000)).

<sup>36</sup> Then-Commissioner Thomas J. Erickson said in 2000, “In short, CFTC has moved from being a ‘front-line’ regulator to an ‘oversight regulator. In general terms, this means that the Commission must take a much more flexible approach to regulation – one which allows industry participants more latitude in

**Table 4 On-board Summary**

	<b>FY 2012</b>	<b>FY 2015</b>	<b>Period Percentage Change</b>
Commission-wide On-Board Total	703	731	4%
DSIO On-Board Total	72	91	26%
NFA On-Board Total	322	528	64%

**NFA May Be Able to Obtain Independent Engagements at Lesser Cost**

CFTC annually assesses and collects fees from NFA for the conduct of oversight reviews, and those fees are remitted to the U.S. Treasury. CFTC publishes NFA’s annual fees (along with its calculation methodology) in the Federal Register each year. For the past several years, CFTC has assessed NFA as follows:

**Table 5. NFA Fees FY 2012 through FY 2015**

<b>Fiscal Year</b>	<b>Amount</b>
2015	\$321,976 <sup>37</sup>
2014	\$363,480 <sup>38</sup>
2013	\$703,445 <sup>39</sup>
2012	\$577,549 <sup>40</sup>

Given the fact that DSIO does not rigorously follow government audit or other recognized or internal standards in the creation of its written reviews of NFA, we are sensitive to appearance issues that may arise from the amounts paid by NFA to CFTC (albeit for deposit to the US Treasury) expressly for CFTC oversight. In addition, we are not certain it is cost-effective for NFA to pay CFTC for DSIO’s written reports. It may be more cost-effective for NFA to engage an IPA or other suitable entity to perform the engagements, similar to its current practice for its financial statement audits, and to provide the resulting audit reports to the Commission. DSIO currently reviews the NFA financial statement audit yearly and could do the same if NFA adopts this course (or if the Commission requires it).

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deciding how best to comply with regulatory requirements.” Commissioner Thomas J Erickson, [Remarks before the National Introducing Brokers Association](#), Chicago, IL, June 23, 2001.

<sup>37</sup> 80 FR 66493 (October 29, 2015).

<sup>38</sup> 79 FR 62418 (October 10, 2014).

<sup>39</sup> 78 FR 52907 (August 27, 2013).

<sup>40</sup> 77 FR 74351 (December 14, 2012).

In addition to benefitting NFA's finances, engaging IPAs to conduct audits of eight program areas on a regular basis could also permit DSIO to devote staff resources to other mission-critical regulatory efforts, such as targeted reviews. Independent engagements could indicate areas of concern for targeted review by DSIO.

## APPENDIX B

### Objective, Scope, and Methodology

Our objective was to evaluate CFTC's oversight of NFA's registration, examination of Futures Commission Merchants and Swap Dealers, written reviews of NFA operations, and follow up of recommendations contained in formal reviews. In addition, we evaluated the impact of NFA's efforts on CFTC staffing levels and the extent to which CFTC is able to leverage NFA's staff. To answer our objective, we:

- Documented our understanding of the NFA oversight function through interviews and reviews of available data;
- Selected Calendar Years (CY) 2012 through 2016 as the scope of the audit given that in October 2011 DSIO reorganized to focus on financial intermediaries;
- Selected eight program areas for evaluation;
- Acquired program reports produced by MRS; and
- Interviewed DSIO staff who interacted daily with NFA staff.

We evaluated DSIO oversight of NFA's service delivery along the following vectors:

- Oversight of Commission established delegated tasks, namely registration, and examination;
- Frequency of DSIO initiated reviews; and
- Follow-up of recommendations.

To evaluate DSIO's approach for assessing NFA's service delivery, we reviewed ten reports produced by DSIO's MRS between CY2012 through CY2016. We acquired a listing of all tasks delegated by the Commission to NFA. We verified delegation authorities to Federal Register Notices and Commission decisions. We conducted interviews with supervisors and senior managers in DSIO to confirm their understanding of tasks delegated to and performed by NFA. We reviewed DSIO's participation in discussions with NFA's annual registrant examination plans, observed quarterly meetings between DSIO management and NFA senior leadership, and reviewed DSIO's controls over tasks performed by NFA staff. We discussed with supervisory auditors in three<sup>41</sup> regional Commission offices their experience with NFA. Specifically, we discussed NFA personnel's knowledge of registrants' current adherence to CEA requirements, NFA personnel's responsiveness to inquiries by Commission staff, and overall performance in delivering delegated tasks.

We planned and completed this audit under *Generally Accepted Government Auditing Standards* (GAGAS). We used data from the Financial Analysis & Audit Compliance Tracking System. We did not verify the reliability of the data; however, nothing came to our attention to question the accuracy of the database content.

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<sup>41</sup> We interviewed DSIO staff located at CFTC offices in New York, Chicago, and Kansas City.

## APPENDIX C

### NFA Background

When Congress created the Commodity Futures Trading Commission (CFTC) (in 1974, it simultaneously authorized CFTC to establish registered futures associations (RFA) with authority to regulate the practices of its members.<sup>42</sup> CFTC granted NFA formal designation as an RFA in 1981,<sup>43</sup> and NFA currently is the sole RFA.<sup>44</sup> NFA is financed exclusively from membership dues and assessment fees and operates at no cost to the taxpayer.

In 1983, Congress authorized the CFTC to delegate registration authority.<sup>45</sup> CFTC delegated this authority to NFA the same year.<sup>46</sup> CFTC currently requires NFA to perform all registration functions for futures commission merchants, retail foreign exchange dealers, introducing brokers, commodity trading advisors, commodity pool operators, swap dealers, major swap participants, leverage transaction merchants, floor brokers, floor traders, and associated persons.<sup>47</sup> NFA's registration functions include evaluation of candidates' fitness,<sup>48</sup> and the conduct of member compliance examinations.<sup>49</sup>

NFA's regulatory role subsequently expanded to include establishing and maintaining computer systems for intermediaries to file financial statements, as well as tasks associated with its role as a DSRO,<sup>50</sup> including ensuring that intermediaries properly disclose risks to customers and collect mandated regulatory filings.<sup>51</sup>

In this audit we identified eight program areas where NFA has responsibilities: 1) registration and examination of Futures Commission Merchants and Swap Dealers, 2) Commodity Pool Operator (CPO)/Commodity Trading Advisor (CTA) special provisions,

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<sup>42</sup> Commodity Futures Trading Commission Act of 1974, Title III, P.L. 93-463, 88 STAT. 1406 (Oct. 23, 1974).

<sup>43</sup> CFTC, Order Granting Registration and Approving Rules (September 27, 1981).

<sup>44</sup> Proposed Rules, Commodity Futures Trading Commission, 17 CFR Parts 1, 23, and 140, 81 FR 91252 (Dec. 16, 2016) ("Currently, the [NFA] is the only RFA under section 17 of the CEA").

<sup>45</sup> Futures Trading Act of 1982, § 224, P.L. 97-444, 96 STAT. 2310 (Jan. 11, 1983). SROs are defined by regulation as a contract market, a swap execution facility, or a registered futures association. 17 CFR 1.3(ee).

<sup>46</sup> 48 FR 35158 (Aug. 3, 1983).

<sup>47</sup> 17 CFR 3.2, 3.10, 3.11, 3.12. Section 17(o) of the CEA, 7 USC 21(o), provides that the Commission may require NFA to perform Commission registration functions in accordance with the Act and NFA rules (as approved by the Commission).

<sup>48</sup> 17 CFR 3.2. See 17 CFR 3.12(h)(1)(iii).

<sup>49</sup> Examinations are performed by NFA staff in its function as DSRO and seek to ascertain members' compliance with Commission regulations. 17 CFR 1.52(c).

<sup>50</sup> NFA serves as DSRO for all SDs and FCMs which are not members of any commodity exchange and, in some cases, NFA by agreement is the DSRO for certain exchange member firms. CFTC Proposed Rules, Foreign Commodity Options, 17 CFR Part 30, 60 FR 63472 (Dec. 11, 1995).

<sup>51</sup> 17 CFR 3.2, 3.75.

3) foreign futures and options special provisions, 4) financial surveillance program, 5) arbitration program, 6) sales practices, 7) telemarketing supervision, and 8) other (which includes NFA disciplinary proceedings and anti-money laundering programs).

Table 6 displays NFA delegations by delegation origin and identifies the DSIO branch largely responsible for monitoring NFA’s oversight. DSIO characterized 31 delegations into 8 major program areas. Most delegated tasks are tied to registration and compliance matters. However, examination of registrants is a significant task performed by NFA. NFA’s examination program follows established protocols for conducting registrant examinations.

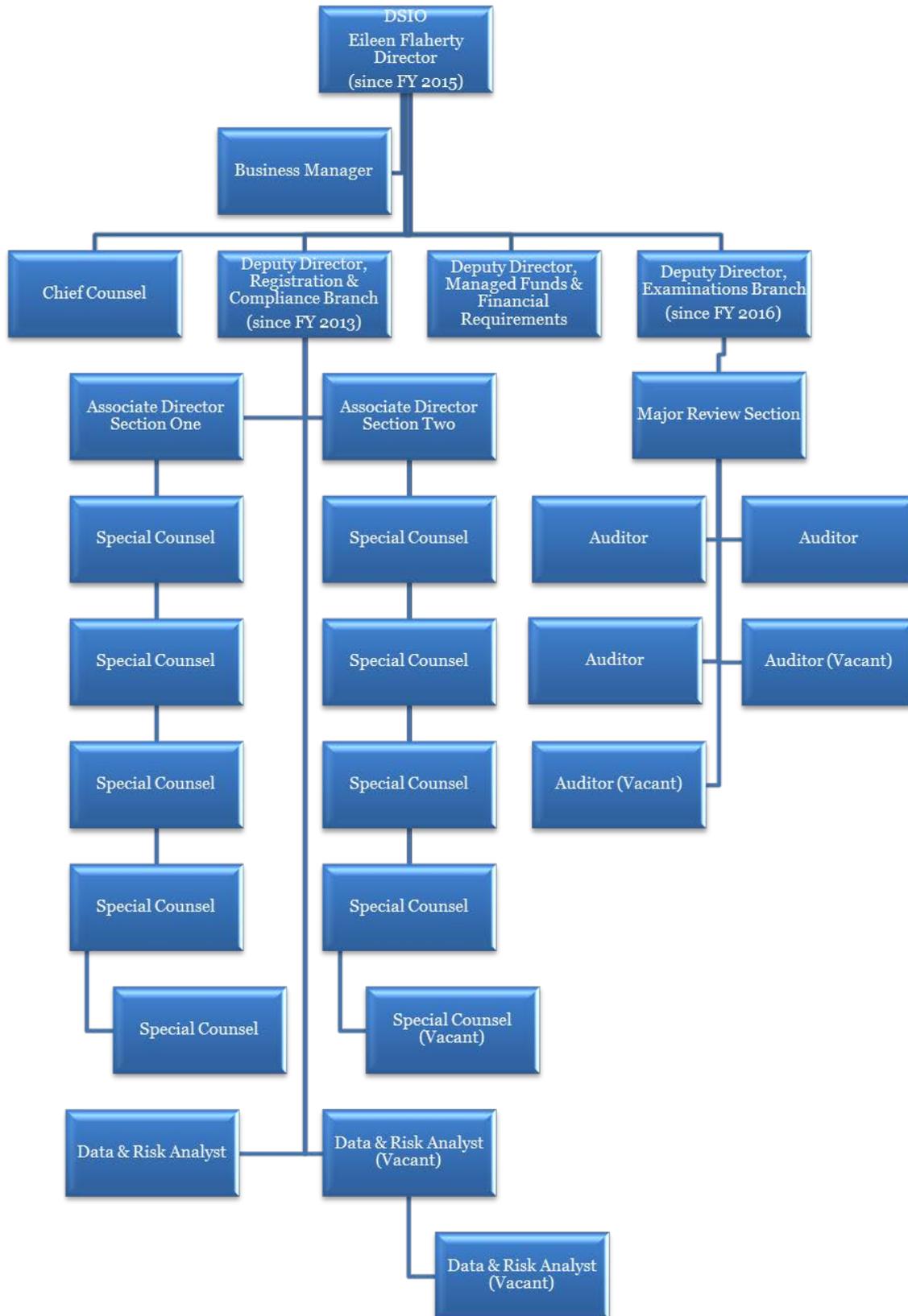
**Table 6 - Oversight Tasks Delegated to NFA**

<b>Delegation Category</b>	<b>Total Delegations to NFA</b>	<b>DSIO Branch Registration &amp; Compliance Branch (R&amp;CB)</b>	<b>DSIO Branch Examinations Branch (EB)</b>
I. Delegations to NFA Pursuant to “Notice and Order” by the Commission	21	19	2
II. Financial filings that have not been delegated to NFA pursuant to "Notice and Order," but pursuant to Commission rules that filings must be submitted to NFA	6	1	5
III. Other Delegations pursuant to the Commodity Exchange Act	4	1	3
<b>Totals</b>	31	21	10

**Source:** Calculated from DSIO supplied data.<sup>52</sup>

<sup>52</sup> Specifically, DSIO provided citation to over 60 CFTC Federal Register releases establishing or amending NFA authorities. In addition, Congress has delegated authority to RFAs as set forth at Section 17 of the Act, 7 USC 21.

## APPENDIX D



## **APPENDIX E**

### **Key Terms and Descriptions**<sup>53</sup>

**Associate** – A person who is registered with National Futures Association (NFA) as an Associate or was so registered when the acts or transactions that are the subject of dispute occurred.

**Commission** – U.S. Commodity Futures Trading Commission (CFTC). Its mission is to foster open, transparent, competitive, and financially sound markets. By working to avoid systemic risk, the Commission aims to protect market users and their funds, consumers, and the public from fraud, manipulation, and abusive practices. To promote market integrity, the CFTC polices the derivatives markets for various abuses. It also seeks to lower the risk of the futures and swaps markets to the economy and the public.

**Division of Swap Dealer and Intermediary Oversight (DSIO)**—Oversees the compliance activities of the futures industry self-regulatory organizations (SROs), including the U.S. futures exchanges, with respect to financial and other requirements applicable to intermediaries. DSIO conducts periodic reviews of SRO programs.

**Designated Self-Regulatory Organizations (DSRO)**—A self-regulatory organizations (i.e., the commodity exchanges and registered futures associations) that enforce minimum financial and reporting requirements for their members, among other responsibilities outlined in the CFTC's regulations. When a futures commission merchant (FCM) is a member of more than one self-regulatory organization (SRO), the SROs may decide among themselves which of them will assume primary responsibility for these regulatory duties and, upon approval of the plan by the Commission, be appointed the 'designated self-regulatory organization' for that FCM.

**Futures Commission Merchant (FCM)** – A futures Commission merchant as that term is used in the Commodity Exchange Act, and that is required to be registered as such under the Commodity Exchange Act and Commission Rules.

**Major Review Section (MRS)**—A business unit of DSIO that conducts program reviews of NFA.

**Major Swap Participants (MSP)** – MSPs maintain a substantial position in swaps for any of the major swap categories as determined by the Commission. The Commodity Exchange Act requires all major MSPs to register as such, unless they already are registered as an MSP or otherwise do not meet the conditions set forth in Commission regulations.

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<sup>53</sup> Summarized from the public CFTC Glossary.

[http://www.cftc.gov/ConsumerProtection/EducationCenter/CFTCGlossary/glossary\\_f](http://www.cftc.gov/ConsumerProtection/EducationCenter/CFTCGlossary/glossary_f).

**Member** – A member of NFA or any other self-regulatory organization.

**Swap Dealers (SDs)** – Regularly enters into swaps with counterparties as an ordinary course of business for its own account or engages in any activity causing the person to be commonly known in the trade as a dealer or market maker in swaps.

The Commodity Exchange Act requires all SDs to register as such, unless they already are registered as an SD or otherwise do not meet the conditions set forth in Commission regulations. All registered SDs are required to be members of the NFA. SDs must satisfy minimum standards for:

- Business conduct standards, including disclosure requirements
- Recordkeeping and reporting requirements
- Swap documentation requirements

**Self-Regulatory Organizations (SROs)**—Exchanges and registered futures associations that enforce financial and sales practice requirements for their members.

**APPENDIX F - MANAGEMENT COMMENTS**

MEMORANDUM

TO: A. Roy Lavik, Inspector General  
Office of the Inspector General

FROM: Eileen T. Flaherty, Director  
Division of Swap Dealer and Intermediary Oversight

DATE: May 25, 2017

SUBJECT: Management Response to the Draft OIG Performance Audit of the Commodity Futures Trading Commission's Oversight of the National Futures Association

The Division of Swap Dealer and Intermediary Oversight ("Division" or "DSIO") of the Commodity Futures Trading Commission ("Commission" or "CFTC") appreciates the opportunity to respond to the Office of the Inspector General's ("OIG") April 28, 2017 Performance Audit of the Division's oversight of the National Futures Association ("NFA") (the "Performance Audit"). The Division's oversight of NFA is part of its general program of ongoing monitoring of the performance of the self-regulatory organizations ("SROs"). The Division's program assesses whether the SROs are adequately meeting their respective obligations to examine futures and swap markets intermediaries and participants for compliance with relevant provisions of the Commodity Exchange Act ("Act"), CFTC regulations, and rules and interpretations of the applicable SROs.

The Commission designated NFA a registered futures association ("RFA") under section 17 of the Act on September 22, 1981, and NFA commenced operations in 1982. As an RFA, NFA is required to meet certain standards set forth in section 17 of the Act, including establishing minimum capital, segregation, and other financial requirements applicable to its members for which such requirements are imposed by the Commission and implementing a program to audit and enforce compliance with such requirements. The Commission also has delegated responsibilities to NFA, commencing with the delegation of certain registration responsibilities in 1983. Furthermore, NFA is a designated self-regulatory organization ("DSRO") as defined under Regulation 1.3(ff). As a DSRO, NFA is responsible for performing the primary financial surveillance of non-clearing futures commission merchants ("FCMs") and retail foreign exchange dealers, and other intermediaries. The Performance Audit is the first review that the OIG has performed of the Division's oversight of NFA, and the Division appreciates the OIG's feedback.

The Division's specific responses to the recommendations contained in the Performance Audit are set forth below.

**OIG Recommendation 1:** *That the Director of DSIO approve a plan for NFA to examine Swap Dealer members for financial requirements after the Commission adopts financial capital rules.*

**DSIO Response:** The Division agrees with this recommendation.

The Performance Audit found that DSIO's oversight of NFA's examinations of FCMs appears adequate. The Performance Audit further found that the Commission has not adopted final regulations imposing capital requirements for swap dealers and, therefore, NFA has not performed swap dealer financial examinations. The OIG recommends that the Director of DSIO approve a plan for NFA to examine swap dealer members for financial requirements after the Commission adopts capital and other financial requirements for swap dealers.

There currently are 101 provisionally-registered swap dealers. While, as explained below, NFA has not yet performed reviews of swap dealer compliance with capital requirements, NFA has performed swap dealer compliance examinations in other areas and to date has issued 98 final reports to swap dealers. These examinations have assessed swap dealers' compliance with material CFTC regulatory requirements, including those concerning risk governance, market practices, market risk, business trading unit responsibilities, recordkeeping, credit risk, and operational risk.

Furthermore, the Commission has adopted final margin rules for swap dealers engaging in swap transactions that are not cleared by a registered derivatives clearing organization ("DCO") or a DCO that has obtained an order exempting it from registering with the Commission. These margin rules became effective September 1, 2016. As part of its financial oversight of swap dealers, NFA performed a comprehensive review and analysis of the margin models submitted by swap dealers subject to the September 1, 2016 effective date to assess the models' compliance with the quantitative and qualitative requirements set forth in Commission Regulation 23.154. A swap dealer is not permitted to use a margin model until it has obtained written approval from NFA. NFA also has started to review the effectiveness of the margin models by reviewing back-testing results prepared by the swap dealers as required by the rules.

DSIO commits to continuing to work with NFA on swap dealer registration and examination issues. In this connection, DSIO will work with NFA to develop an examination program for assessing swap dealers' compliance with relevant capital requirements once the Commission adopts final capital rules for swap dealers.

**OIG Recommendation 2:** *That the Director of DSIO adopts written standards for reviews of NFA, including a periodic schedule for completion.*

**DSIO Response:** DSIO agrees that its examinations of NFA program areas should follow written standards. DSIO, however, disagrees that it currently does not follow written standards in conducting oversight examinations of NFA. Further, DSIO has a schedule for completion.

Based upon the detailed findings set forth in Appendix A of the Performance Audit, DSIO understands that the recommendation is directed to the written reports that are prepared as part of the NFA oversight examination. DSIO understands that the recommendation does not extend to other areas of the NFA examinations including: (1) the technical training and proficiency of staff; (2) independence of staff; (3) due professional care in the performance of the examination, planning and supervision of field work by staff; (4) documentation of examination evidence to support conclusions; and, (5) staff's process for obtaining an understanding of NFA for purposes of assessing examination risk. In this connection, Appendix A of the Performance Audit states that based upon the OIG's field work, it is satisfied that DSIO generally documents its work for its written reviews. Furthermore, DSIO provided OIG staff with detailed written programs for the examination of NFA that are maintained in the audit software database.

Consistent with DSIO's understanding regarding the scope of the recommendation, DSIO notes that the Performance Audit states that for the written reviews conducted DSIO does not rigorously follow government audit or other recognized quality standards. The Performance Audit further states that consistently following quality standards would permit DSIO to uniformly report NFA's performance over time and facilitate recommendation follow-up. The Performance Audit, however, further states that DSIO is not required to follow any government audit standards or other recognized quality reporting standards as part of its SRO examination program.

DSIO agrees that it is not required to follow government audit or other audit standards in the preparation of examination reports.<sup>1</sup> DSIO is not subject to government audit standards or generally accepted auditing standards issued by the American Institutes of Certified Public Accountants ("AICPA") because such standards are not applicable to the types of examinations that DSIO performs in its oversight of NFA. In this regard, Generally Accepted Government Auditing Standards ("GAGAS") specifically includes the statement that "[GAGAS] standards are for use by auditors of government entities and entities that receive government rewards and audit organizations performing GAGAS audits."<sup>2</sup> None of these stated situations are applicable to DSIO's oversight of NFA's financial surveillance program. In addition, AICPA audit

<sup>1</sup> DSIO also notes that it is not required to follow government audit standards or any other recognized standards in the conduct of its examinations of NFA in any area, including reporting.

<sup>2</sup> See Paragraph 1.04, *Purpose and Applicability of GAGAS*, Government Auditing Standards (2011 Revision), U.S. Government Accountability Office.

standards for reporting are applicable to the expression of an audit opinion regarding the presentation of financial statements in accordance with generally accepted accounting principles. This situation also is not applicable to DSIO's oversight of NFA.

Notwithstanding that DSIO is not required to follow GAGAS or AICPA auditing standards in conducting examinations, including the preparation of examination reports, DSIO does generally incorporate similar procedures and requirements as are included in such standards into its reporting. In this regard, DSIO's examination reports for its examinations of the NFA financial surveillance program contain: (1) an explanation of the period of time that the examination covers; (2) the purpose of the examination; (3) a description of the NFA program areas subject to the examination; (4) the methodology that staff employed in conducting the examination; (5) the examination findings and recommendations; (6) and, a statement of the date of the exit conference with NFA. These requirements are generally consistent with the content of reporting standards under both GAGAS standards and AICPA generally accepted auditing standards.

DSIO understands that the impetus for the recommendation is the OIG's belief that a more fulsome discussion of the methodology and standards of the examination should be included in future written reports. DSIO has no objection to providing additional details on these points in the written reports during future examinations.

With respect to the recommendation that the Division maintain a written schedule of the completion of examinations, DSIO has a three year written schedule of examinations.

**OIG Recommendation 3:** *That the Director of DSIO evaluate NFA's performance of delegated tasks related to the Arbitration Program, CPO/CTA special provisions, Foreign Futures and Options and "other" or:*

*Following a study of costs, require NFA to submit its eight program areas to engagements (as scheduled) by an independent public accountant (IPA) or other suitable entity whenever it would be cost-effective for the NFA or CFTC.*

**DSIO response:** DSIO agrees that there should be a formal schedule for the oversight of NFA SRO programs and/or delegated responsibilities. In this connection, DSIO currently maintains a three-year examination schedule of NFA financial and non-financial program areas. This three-year schedule was established independent of the Performance Audit in March 2016 at the request of current Division management, and a copy has been provided to OIG staff. The current schedule lists examinations that are to be performed during the fiscal years ending September 30, 2017 through 2019.

The Performance Audit uses a three-year period as a benchmark to assess the timeliness of DSIO's examinations of the different NFA program areas. DSIO does not agree that each NFA program area should be examined once every three years.

DSIO believes that the frequency of DSIO examinations of NFA program areas should be risk-based, with greater emphasis on and frequency of examinations of NFA program areas that, if not effectively performed, pose a greater risk to customers, market participants, and/or the financial system as a whole. In this regard, as noted in the Performance Audit, the Division has performed examinations of NFA's FCM financial surveillance program once every six months during the period of review. DSIO places a high degree of emphasis on the NFA FCM financial surveillance program as it addresses FCMs' compliance with capital, the segregation of customer funds, financial reporting, margin practices, and anti-money laundering among other provisions which are considered higher-risk if not effectively overseen. DSIO believes that given the central function that FCMs have in ensuring the safety of customer funds and the effective operation of the futures markets, that such program areas should be reviewed more frequently than once every three years and more frequently than other NFA program areas.

Other NFA program areas pose a much lower degree of risk to customer funds and the safety of the financial system and, therefore, those should be and are subject to less frequent examination. For example, only seven FCMs were subject to the NFA telemarketing restrictions during the most recent DSIO examination of the NFA telemarketing program. Accordingly, DSIO would not perform a review of this area regularly, even on a routine three-year cycle unless for alternate reasons significant issues were raised.

The Performance Audit also identifies the following NFA program areas as not being subject to an examination by the Division during the OIG's review period of January 1, 2012 through December 31, 2016: (1) Arbitration Program; (2) CPO/CTA special provisions; (3) Foreign Futures and Options (Part 30) programs; and (4) tasks falling in the catch-all category "Other." DSIO agrees that examinations were not completed for the arbitration program or CPO/CTA special provisions during the period 2012 through 2016. A review of the NFA arbitration program, CPO/CTA special provisions program and Foreign Futures and Options (Part 30) are currently scheduled as part of the three year written schedule.

The "Other" category includes NFA disciplinary proceedings and anti-money laundering programs. The DSIO November 2015 examination of NFA's financial surveillance program included the review of NFA's oversight of FCM's compliance with relevant anti-money laundering regulations. This examination also reviewed NFA's disciplinary proceedings. The final November 2015 DSIO written report was provided to NFA at the conclusion of the examination, and a copy of the written report was provided to OIG staff during the Performance Audit.

Lastly, the "Other" category also includes the Division's assessment of whether NFA has "rules designed to prevent fraudulent and manipulative practices, and to promote just and equitable principles of trade, in general, to protect the public interest and remove impediments to and

perfect the mechanism of free and open futures trading.”<sup>3</sup> DSIO does not agree that it has not conducted a review of NFA rules during the review period. NFA is required under section 17(j) of the Act to submit every rule (whether a rule addition, rule deletion, or rule amendment) which is reviewed by DSIO prior to submitting to the Commission for its review and approval. Accordingly, the Commission has reviewed every rule and rule amendment that NFA has adopted since its approval as an RFA in 1981 to the present.

DSIO does not agree with the recommendation to require NFA, following a study of costs, to submit its eight program areas to engagements (as scheduled) by an independent public accountant (IPA) or other suitable entity whenever it would be cost-effective for the NFA or CFTC. Section 3(a) of the Act states that transactions subject to the Act are entered into regularly in interstate and international commerce and are affected with a national public interest by providing a means for trading in liquid, fair and financially secure trading facilities. Section 3(b) provides that the purpose of the Act is to serve the public interest described in Section 3(a) through a system of effective self-regulation of trading facilities, clearing systems, market participants and market professionals under the oversight of the Commission.

The outsourcing of the Commission’s direct oversight of NFA’s performance of its statutory, regulatory and delegated responsibilities to a third-party independent public accountant is inconsistent with Section 3 of the Act. In addition, in such a situation, NFA would be the client and the party in the contractual relationship with the independent public accountant. Accordingly, the Commission would have no jurisdiction over the independent public accountant and may be limited in its ability to review the independent public accountant’s work product or to discuss the independent public accountant’s work at NFA.

DSIO believes that direct and active oversight of NFA is necessary to perform the responsibility of proper oversight and outsourcing resulting in merely reviewing a report by a third party would not satisfy those obligations. Further, DSIO has significant doubts as to whether independent public accounts can adequately oversee and assess NFA’s oversight programs for compliance with the Act, Commission regulations, and NFA rules and interpretations, particularly at a substantial savings over the fees assessed by the Commission. The eight program areas identified in the Performance Audit cover a broad spectrum of NFA oversight responsibilities, including registration, foreign futures, telemarketing, sales practices, FCM examinations, capital, segregation of customer funds, anti-money laundering, CPO financial reporting, introducing broker financial reporting, swaps reporting requirements, swaps business conduct requirements, swaps margin requirements, regulatory notices, and other areas. DSIO is not confident that any independent public accounting firm or other entity has the expertise to perform a detailed assessment of the effectiveness of NFA’s oversight of such a broad range of complex regulatory areas. Furthermore, as noted above, without jurisdiction over these service providers, the

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<sup>3</sup> See Table 1 – Reviews of NFA Major Program Areas, pages 7-8 of the Performance Audit.

Commission has no mechanism to bring a disciplinary action against them for failure to properly assess NFA's oversight programs.

**OIG Recommendation 4:** *That the Director of DSIO furnish all final written reviews and audits to NFA and to the Commission and revisit disclosure policies.*

**DSIO Response:** DSIO agrees with the recommendation that all final written reviews of NFA program areas should be provided to NFA and to the Commission.

General DSIO policy for many years was for written reports to be prepared at the conclusion of each review of an SRO's program area. The SRO subject to the review would then have an opportunity to prepare a written response to the Division's findings and recommendations. The final written reports were provided to the SRO and copies were provided to the Commission. This practice was stopped several years ago and final reports were not issued to the SROs.

DSIO acknowledges that NFA did not receive final written reports for six reviews that DSIO conducted of the NFA financial surveillance program, spanning February 2012 through April 2015. While the findings and recommendations contained in the draft reports or staff work papers were communicated to NFA staff either via email or during the examinations, NFA was not provided with a final report, nor was NFA required to acknowledge receipt of the findings and recommendations. The decision to not issue final written reports for the six reviews was made by prior DSIO management. Current DSIO management revised this policy prior to the Performance Audit to require that NFA receive a final written report for all reviews.

Current management's change in policy to provide NFA with a written final report is reflected in the Performance Audit. In this regard, DSIO provided NFA with a final written report for the four most recent DSIO examinations covered by the Performance Audit (the Financial Surveillance examinations performed as of November 2015, May 2016, and August 2016, and the Registration examination performed as of November 2016). In addition, DSIO provided a final written report in April of 2017 to NFA covering the Division's examination of the NFA telemarketing and promotional material program. The telemarketing and promotional material examination was conducted outside of the timeframe of the Performance Audit.

The Performance Audit also contains a recommendation that the DSIO Director revisit the current practice of not publicly disclosing the final written reports of DSIO examinations of NFA. DSIO notes that its practice currently mirrors the guidance provided by the Commission in 2002 when it adopted a policy not to disclose the written reports of staffs' examinations of the SRO financial surveillance programs of contract markets and examinations of DCOs.

While DSIO believes that there should be no change to the current practice, which, as noted above, is consistent with the Commission's 2002 policy, it further believes that any change should be made in consultation with the Commission and not solely by DSIO staff. DSIO will, however, elevate this issue to the Commission for its consideration.

*OIG Recommendation 5: That the Director of DSIO establish a system for tracking status and closing recommendations.*

**DSIO Response:** DSIO agrees with the recommendation. In response to this recommendation, DSIO has implemented a centralized system to track the status of all recommendations arising from NFA financial and non-financial examinations. The centralized tracking system will further document the closing of recommendations.

The Performance Audit states that for certain examinations, DSIO discussed recommendations with NFA on an ongoing basis but did not formally track or otherwise document the follow-up process through recommendation closeout. The Performance Audit further states that DSIO does not preserve a status log of recommendations made to NFA.

As DSIO notes above, DSIO agrees that a centralized recommendations log for financial and non-financial examinations is appropriate, and this recommendation has been implemented. However, the Performance Audit's description of DSIO's process for documenting and tracking the status and closing of recommendations made during examinations is not accurate.

Staff fully documents recommendations for each financial and non-financial examination in staff's work papers and in the written reports. Specifically, with respect to the financial examinations, recommendations are maintained in the audit software database and staff conducts the necessary follow-up on the status of the recommendations during the conduct of subsequent examinations. As examinations of NFA's financial surveillance program were generally performed once every six months during the period of time covered by the Performance Audit, staff was able to effectively track that status of recommendations from prior examinations within reasonable timeframes.