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BEFORE THE COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS
U.S. SENATE

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My name is Daniel Roth, and I am President and Chief Executive Officer of National Futures Association. Thank you Chairman Shelby and members of the Committee for this opportunity to appear here today to present our views on some of the issues facing Congress as it considers legislation to reauthorize the Commodity Futures Trading Commission ("CFTC"). NFA recognizes the importance of completing the reauthorization process as quickly as possible. At the same time, however, we feel that Congress must deal with important issues involving the protection of unsophisticated retail customers.

NFA is the industry-wide self-regulatory organization for the U.S. futures industry. Regulation is all we do at NFA—we do not operate a marketplace and we are not a lobbying organization. As a regulator, NFA is first and foremost a customer protection organization. Our mission is to provide the futures industry with the most effective and the most efficient regulation possible.

Our approximately 4,000 Members include futures commission merchants ("FCMs"), introducing brokers ("IBs"), commodity pool operators ("CPOs") and commodity trading advisors ("CTAs"). We also regulate approximately 54,000 registered account executives who work for our Members.

As a regulator, NFA's main responsibilities are many and varied. We establish rules and standards to ensure fair dealing with customers; we perform audits

and examinations of our Members to monitor their compliance with those rules; we conduct financial surveillance to enforce compliance with NFA financial requirements; we provide arbitration and mediation of futures-related disputes; we perform trade practice and market surveillance activities for a number of exchanges; and we conduct extensive educational programs both for the investing public and for our Members. We also perform a number of regulatory functions on behalf of the CFTC, including the entire registration process—from screening applicants for fitness to taking actions to deny or revoke registrations when those fitness standards are not met. We perform these duties with a staff of approximately 235 people and a budget of over $35 million, all of which is paid by the futures industry. Since NFA began operations in 1982, volume on U.S. futures markets has increased by over 1,200%—a great testament to the innovation and value of our futures markets. What most people don't realize is that during that same time period customer complaints in the futures industry are down by almost 75%. This drop in customer complaints was not an accident. It was the result of a close partnership between the CFTC, NFA and the rest of the industry to make sure that we are allocating resources where they are most needed, that we do not duplicate each other's efforts and that precious regulatory resources are not squandered.

In the last reauthorization process, Congress made bold changes to the Commodity Exchange Act ("CEA"). The Commodity Futures Modernization Act ("CFMA") rejected a highly prescriptive, outmoded approach to regulation in favor of a more flexible approach that focused regulatory protections where they were most needed. I am pleased to join the rest of the industry in noting the great success of the CFMA and the superb work of the CFTC in implementing exactly the kind of flexible

regulatory approach that the CFMA envisioned. The CFTC and its staff have worked to reduce unnecessary and costly regulatory burdens for every segment of the industry while preserving the highest level of customer protection.

Though the CFMA has been a great success, it failed in one of its objectives that directly impacts customer protection. Before the CFMA, boiler rooms had found their unregulated niche in off-exchange forex, where widespread retail fraud was occurring. Congress attempted to resolve the so-called Treasury Amendment issue once and for all in the CFMA by clarifying that the CFTC does, in fact, have jurisdiction to protect retail customers investing in off-exchange foreign currency futures. The basic thrust of the CFMA in this area was that foreign currency futures with retail customers were covered by the Act unless the counterparty was an "otherwise regulated entity," such as a bank, a broker-dealer or an FCM. Unfortunately, as we sit here today, there is as much uncertainty over the CFTC's authority to protect retail customers as there was five years ago. This uncertainty is clearly not what Congress intended in passing the CFMA.

The main problem stems from a decision in the Seventh Circuit Court of Appeals in a forex fraud case brought by the CFTC, the so-called <u>Zelener</u> case. In Zelener, the District Court found that retail customers had, in fact, been defrauded but that the CFTC had no jurisdiction because the contracts at issue were not futures. The Seventh Circuit affirmed that decision. The "rolling spot" contracts in <u>Zelener</u> were marketed to retail customers for purposes of speculation; they were sold on margin; they were routinely rolled over and over and held for long periods of time; and they were regularly offset so that delivery rarely, if ever, occurred. In <u>Zelener</u>, though, the Seventh

Circuit based its decision that these were not futures contracts predominantly on the terms of the written contract itself. Because the written contract in Zelener did not include a guaranteed right of offset, the Seventh Circuit ruled that the contracts at issue were not futures.

Zelener creates the distinct possibility that, through clever draftsmanship, completely unregulated firms and individuals can sell retail customers contracts that look like futures, act like futures and are sold like futures and can do so outside the CFTC's and any other federal regulatory body's jurisdiction. To make matters worse, the rationale of the Zelener decision is not limited to foreign currency products. It is very likely that unsophisticated retail customers will be victimized by high-pressured sales pitches for futures look-alike products covering everything from foreign currencies to precious metals to heating oil. The CFMA recognized that these retail customers are the ones who most need regulatory protection, and that protection should not be stripped from them because a clever lawyer finds a loophole in the law.

I recognize that Zelener is just one case, and we should not overreact to it. It's true that the Zelener decision would allow the CFTC in other cases to present evidence that the FCM made oral representations about the customer's right to offset. But the reality is that those cases will be almost impossible to bring. First, in most cases the sales pitch is not made by the FCM but by an unregistered, unregulated solicitor. It's not clear to me that any court would find that the nature of the contract between the customer and the FCM was transformed into a futures contract because of oral representations made by some third party, registered or not. Second, if the written contract is vague about a right of offset, I can guarantee that the salesman working the

phone will be even more evasive. In my opinion, trying to work our way out of the Zelener problem through future enforcement actions puts an awful lot of chips on a bet that's no sure thing.

We strongly believe that the Zelener decision makes it much harder for the CFTC to prove that contracts sold to retail customers to speculate in commodity prices are futures, makes it easier for the unscrupulous to avoid CFTC regulation and creates a real, live customer protection issue. Therefore, it's NFA's view that Congress should address this issue.

The trick is to protect retail customers without upsetting jurisdictional boundaries that were agreed to in the CFMA. We agree with the CFTC and the industry that Zelener is not an easy problem to resolve. But it must be done if we are to protect retail customers from unscrupulous firms and individuals and the solution should not be limited to forex. Some have suggested that the best approach is to address Zelener only with respect to forex products on the grounds that forex is where the bulk of the fraud is occurring. I agree that forex is the current scam of choice among fraudsters and I know that those who favor a narrow fix have the best of intentions, but limiting a Zelener fix to forex ignores the history of sales practice fraud and will not, in our view, really address the problem.

In NFA's 20-years of experience we have seen that boiler rooms really prefer to sell physical commodities that retail customers deal with all the time. Sugar, gold, unleaded gasoline, heating oil—these are the products that boiler rooms have historically favored. Foreign exchange rates, by contrast, are fairly arcane. Forex fraud mushroomed, however, after the 9th Circuit's 1996 Frankwell Bullion decision made

clear that the CFTC had no jurisdiction over forex futures contracts offered to retail customers. Congress attempted to deal with that problem in the CFMA, but the Zelener case basically negated that effort and made things worse by providing fraudsters with a road map on how to avoid CFTC jurisdiction not just for forex futures but for anything else. We are concerned that if Congress adopts a forex only fix to Zelener it will not close the unregulated niche—it will just move it to other commodities.

NFA and the exchanges have developed a fix to Zelener that goes beyond forex and does not have unintended consequences. Our approach codifies the approach the 9th Circuit took in CFTC v. Co Petro—which was the accepted and workable state of the law until Zelener—without changing the jurisdictional exemptions in Section 2(c). In particular, our approach would create a statutory presumption that leveraged or margined transactions offered to retail customers are futures contracts if the retail customer does not have a commercial use for the commodity or the ability to make or take delivery. This presumption is flexible and could be overcome by showing that the transactions were not primarily marketed to retail customers or were not marketed to those customers as a way to speculate on price movements in the underlying commodity. I have attached a copy of our proposed language.

Our approach has a number of advantages.

- First, it codifies Co Petro and returns the law to its pre-Zelener state. This would give the CFTC jurisdiction over traditional futures contracts without expanding it.
- Second, it does not touch the interbank currency market.

- Third, Section 2(c) would continue to exempt the retail OTC forex activities of banks, broker-dealers, insurance companies, and similar entities from CFTC jurisdiction.
- Fourth, our approach does not change any of the CFMA exemptions for off-exchange transactions entered into by eligible contract participants.
- And last, but certainly not least, it protects retail customers by giving the CFTC the power to shut down unregulated boiler rooms and freeze their funds.

Our presumption is not meant to address already regulated instruments like securities and banking products. It would, however, ensure that scammers cannot tailor their written agreements to sell leveraged commodity products to retail customers for speculative purposes in a completely unregulated environment.

NFA believes that the solution to Zelener should go beyond forex. Others disagree. One thing we all agree on, though, is that if Congress does not adopt a broad fix to Zelener now and boiler rooms move to other commodities using Zelener-type contracts, Congress must be willing to re-open the Commodity Exchange Act before the next reauthorization.

Unfortunately, the Zelener decision is not the only problem we have encountered with retail forex. Since passage of the CFMA, a number of firms—that do not engage in any other regulated business—have nonetheless registered as FCMs to qualify to be an otherwise regulated entity and have become NFA Forex Dealer Members for the sole purpose of acting as counterparties to retail customers in these transactions. For example, just two years ago, NFA had 14 active Forex Dealer Members and those Members held approximately $170 million in retail customer funds.

Since then, the retail forex business has continued to grow by leaps and bounds. Today, NFA has 31 active Forex Dealer Members holding over $700 million in customer funds. That growth has not been problem free.

Though less than 1% of our Member firms, forex dealers have accounted for 50% of our emergency enforcement actions and over 10% of our arbitration docket. I know the CFTC has been very aggressive in enforcement cases involving forex, though most of those cases have involved unregistered firms.

Obviously, retail forex has consumed a good deal of resources at NFA, but we are committed to doing whatever it takes to get our job done. Late last year we appointed a blue ribbon committee to review all of our forex rules. It recommended, and our Board adopted, additional rules to strengthen both our financial requirements and sales practice rules for forex. We will continue to enforce our rules vigorously and bring actions whenever necessary to ensure compliance with our rules. Part of the problem, though, is that some firms can operate beyond our reach, in a completely unregulated environment, because of an unintended glitch in the wording of the CFMA.

As I mentioned before, the basic thrust of the CFMA was that only "otherwise regulated entities" could offer retail customers off-exchange foreign currency futures. Unfortunately, the wording of the statute only requires the counterparty to be an otherwise regulated entity. This creates the possibility that an FCM, for example, might be the counterparty but the firm that actually does the telemarketing for these products is completely unregistered and unregulated. There are literally hundreds of these unregulated firms doing telemarketing of off-exchange forex transactions to retail customers and in some instances the people making the sales pitches have been

barred from the futures industry for sales practice fraud. I don't think that's what Congress intended at all and NFA would support an amendment to Section 2(c) of the Act to make clear that not only the counterparties but also the persons actually selling these products to retail customers must be "otherwise regulated entities."

There's one more forex problem I should mention, though we are hopeful that it's a problem we can solve through NFA rules without any further legislation from Congress. Section 2(c) of the CEA could be read to allow unregulated affiliates of FCMs to act as counterparties to retail customers if the FCM makes and keeps records of the affiliates under the CEA's risk-assessment provisions. Some firms have tried to take advantage of this provision of the Act by creating "shell" FCMs. These shell FCMs do not do any futures business and they do not do any retail forex business. Their sole reason for existence seems to be to create affiliates that do retail forex business in a completely unregulated environment.

I don't think that that's what Congress had in mind. Therefore, NFA is currently working on a solution to adopt a larger minimum capital requirement for FCMs with retail forex affiliates. We hope these efforts will solve the shell FCM problem without the need for legislative relief.

In closing, let me state that NFA believes the industry and the public have benefited greatly from the enlightened regulatory approach that Congress adopted in the CFMA and from the CFTC's role in implementing the Act. We look forward to working with this Committee, other Congressional committees, the CFTC, and the industry to address the issues outlined above.

PRESUMPTION REGARDING JURISDICTION.—

Leveraged or margined transactions that are offered to, or entered into with, persons who are not eligible contract participants, shall be presumed to be contracts for the sale of a commodity for future delivery subject to this Act if such non-eligible contract participant does not have a commercial use for the commodity or the financial capacity and the physical capacity to make or take delivery, or to effect a cash settlement where no physical delivery occurs. This presumption may be overcome by showing that the transaction was: (1) primarily marketed to eligible contract participants or (2) not marketed or offered to non-eligible contract participants as a means to speculate on price movement in the underlying commodity.