



**TESTIMONY OF DANIEL J. ROTH
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**BEFORE THE
COMMITTEE ON AGRICULTURE
U.S. HOUSE OF REPRESENTATIVES**

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My name is Daniel Roth, and I am President and Chief Executive Officer of National Futures Association. Thank you, Chairman Peterson and members of the committee, for this opportunity to present our views on legislation to bring greater transparency and accountability to commodity markets.

NFA is the industry-wide self-regulatory organization for the U.S. futures industry. NFA is a not for profit organization, we do not operate any markets, we are not a trade association. Regulation and customer protection is all that we do.

NFA certainly understands the importance of responding to the current financial crisis, dealing with systemic risk and creating greater transparency in OTC markets. NFA would like to point out that as a result of bad case law, more and more retail customers are being victimized in off-exchange futures markets. This is a customer protection issue that needs to be addressed now.

Customer Protection

For years, unsophisticated, retail customers that invested in futures had all of the regulatory protections of the Commodity Exchange Act. Their trades were

executed on transparent exchanges, their brokers had to meet the fitness standards set forth in the Act and their brokers were regulated by the CFTC and NFA. Today, for too many customers, none of those protections apply. A number of bad court decisions have created loopholes a mile wide and retail customers are on their own in unregulated, non-transparent OTC futures-type markets.

Congress acted to close those loopholes last May with respect to forex trading but customers trading other commodities, such as gold and silver, are still stuck in an unregulated mine field. It's time to restore regulatory protections to all retail customers.

Let me remind you how we got here. In the *Zelener* case, the CFTC attempted to close down a boiler room selling off-exchange forex trades to retail customers. 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, and the Seventh Circuit affirmed that decision. The "rolling spot" contracts in *Zelener* 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 *Zelener*, though, the Seventh Circuit based its decision that these were not futures contracts exclusively 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.

For a short period of time, *Zelener* was just a single case addressing this issue. Since 2004, however, various Courts have continued to follow the Seventh

Circuit's approach in *Zelener*, which caused the CFTC to lose enforcement cases relating to forex fraud. Last year Congress plugged this loophole for forex contracts but not for other commodities.

Unfortunately, the rationale of the *Zelener* decision is not limited to foreign currency products. In testimony before this Subcommittee in 2007, I predicted that if Congress only addressed the forex aspect of the *Zelener* decision, the fraudsters would merely move their activities to other commodities. That's just what has happened. We cannot give you exact numbers, of course, because these firms are not registered. Nobody knows how widespread the fraud is, but we are aware of dozens of firms that offer *Zelener* contracts in metals or energy. Some of these firms are being run by individuals that we have kicked out of the futures industry for fraud. Several weeks ago, we received a call from a man who had lost over \$600,000, substantially all of his savings, investing with one of these firms. We have seen a sharp increase in customer complaints in the last three months. It is safe to say that these unregulated bucket shops have plundered millions of dollars from retail customers.

NFA and the exchanges have previously proposed a fix to *Zelener* that goes beyond forex and does not have unintended consequences. Our approach codifies the approach the Ninth Circuit took in *CFTC v. Co-Petro*—which was the accepted and workable state of the law until *Zelener*—without changing the jurisdictional exemption in Section 2(c) of the Act. 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.

This statutory presumption would effectively prohibit off-exchange contracts—other than forex—with retail customers when those contracts are used for price speculation. This is the cleanest solution and the one NFA prefers. If Congress is hesitant to ban these transactions, however, they should at least be regulated in the same manner as retail OTC forex futures contracts. (See Section 2(c)(2)(B) of the Act.)

Commission Resources

NFA strongly supports the bill's effort to provide the Commission with much-needed resources. CFTC staffing levels are at historic lows. As trading volume rose over the years, staffing levels moved in the other direction. Something here is not right. It is always a struggle for a regulator to keep up with an ever changing market place, but that becomes harder and harder to do when you have fewer people on hand to do more work. NFA applauds proposals for emergency appropriations to the CFTC to hire additional people and upgrade its technology.

Position Limits

NFA is concerned with the proposal to impose position limits on futures contracts for excluded commodities. In 2000, Congress amended the Commodity Exchange Act to define certain commodities as “excluded commodities.” These are primarily financial commodities, indices, and contingencies. By their very nature,

excluded commodities are not susceptible to manipulation, either because there is such a large supply that it cannot be cornered or because, as with the contingencies, the contracts are based on events that are beyond anyone's control. Therefore, position limits in excluded commodities serve no purpose except to reduce the liquidity that helps banks and other institutions manage their risks. Furthermore, this reduced liquidity would come at a time when risk management is more critical than ever.

Credit Default Swaps

Section 16 of the draft bill is an even greater threat to liquidity. That section appears to restrict the use of credit default swaps to hedgers. NFA supports efforts to bring greater transparency to these transactions and to reduce their systemic risk. This proposed remedy, however, is likely to kill the patient. You cannot have an effective market if you do not have liquidity and you cannot have liquidity if you do not have speculators. Eliminating speculators from the credit default swap market will make it much more difficult for firms to manage their risks, which cannot be good for those firms or for the economy.

Mandatory Clearing of OTC Derivatives

Clearing organizations in the U.S. futures markets have performed superbly for over 100 years. The current financial crisis has posed the ultimate test to the clearing system—a test that was passed with the highest possible grades. Even under the greatest market stress we have seen for generations, no futures customers lost money due to an FCM insolvency and positions were transferred from distressed

firms to healthy ones smoothly and efficiently. There has been no federal bailout necessary for the futures industry. Clearing in the futures markets works and the spread of clearing to OTC markets can be a very positive development.

All OTC derivatives, however, are not like futures. It is the standardized nature of futures contracts and the ability to mark them to a liquid and transparent market that make clearing work so well. Many OTC instruments are quite standardized and susceptible to clearing. Others, though, are highly individualized and privately negotiated and difficult to mark to a market. The bill attempts to recognize these problems by providing the CFTC with exemptive authority. That authority, however, is circumscribed. I suspect it is impossible to draft legislation that can take into account all of the factors that might make it appropriate to exempt an OTC transaction from mandatory clearing. We would suggest that the bill give the CFTC greater flexibility to exercise its exemptive authority.

In conclusion, NFA's overriding concern with the bill is in what it does not contain. Retail customers trading in OTC metals and energies should not be left at the mercy of scammers. We encourage the Committee to revise the draft to prohibit—or at least regulate—*Zelener*-type contracts in commodities other than currencies.

As always, NFA looks forward to working with the Committee, and I would be happy to answer any questions.