



**TESTIMONY OF DANIEL J. ROTH
PRESIDENT AND CHIEF EXECUTIVE OFFICER
NATIONAL FUTURES ASSOCIATION**

**BEFORE THE COMMITTEE ON AGRICULTURE
U.S. HOUSE OF REPRESENTATIVES**

July 25, 2012

Thank you, Mr. Chairman. My name is Daniel Roth and I am the president of National Futures Association. For years the futures industry has built an impeccable reputation for safeguarding customer funds deposited at FCMs in connection with futures trading. Now, for the second time in just nine months, we are dealing with a shortfall in customer segregated funds at an FCM. Once again, customers have suffered real harm, the type of harm that all regulators attempt to prevent.

The full facts are not yet known, but it appears that Peregrine's customer losses are the result of an elaborate fraud achieved through a set of forgeries and falsities rooted in both the firm's external and internal financial records. Forged external records included bank statements, bank confirmations, print-outs of daily online summary reports of bank balances, cashier's checks, bank acknowledgement letters, bank deposit tickets and bank receipts all purportedly from US Bank. The firm's internal financial records, including daily and month-end account reconciliations, general ledgers and trial balances were also false to the extent they were based on forged US Bank records. Moreover, Peregrine submitted to NFA false daily segregation reports, monthly financial statements and segregated investment detail reports, and annual certified financial statements. Even the firm's customer statements were false to the extent the firm led customers to believe that sufficient assets were on deposit to cover customers' liabilities.

I would like to review for this committee the recent chronology of events surrounding the Peregrine fraud, the fundamental changes that need to be made in the way we protect customer funds and monitor firms for compliance with the rules, how we are going to make those changes and the steps we have already taken.

NFA began an examination of Peregrine in mid-June. During the audit, we informed Peregrine staff that NFA was changing its method for obtaining bank confirmations to a web-based e-confirmation process. We had completed the necessary data entry for this process by the first week in July, and told Peregrine staff that the firm must authorize its participation in the e-confirmation process. On Sunday,

July 8, Mr. Wasendorf, the Chairman of Peregrine, provided the required authorization that was sent to him a week earlier. The next day he attempted suicide.

As of the close of business on July 6th, the previous Friday, Peregrine had reported to us that the firm was holding approximately \$380 million in customer segregated funds, with just over half of that amount on deposit at US Bank. On July 9th, Peregrine notified the CFTC and NFA of Wasendorf's attempted suicide and we immediately joined in a teleconference with Peregrine staff. We directed firm personnel to go to the bank and have the bank manager join the conference call to confirm the balances as of the previous Friday. The bank manager informed us that the actual balance in the account was approximately \$5 million.

We then asked about the balances on the dates for which NFA had received written bank confirmations in our two most recent audits—in 2010 and 2011. Those bank confirmation requests had been mailed by NFA to the P.O. Box on the purported bank acknowledgment letter we had received for the customer segregated account. (In our experience, it is not at all uncommon for banks holding customer segregated funds to use P.O. Boxes to receive confirmation requests since it is a means for them to control the vast amount of paperwork they receive.) In this case, the bank manager informed us that the balances reflected on the two most recent confirmations received by NFA in 2010 and 2011 were similarly inflated.

NFA immediately issued an emergency Member Responsibility Action, freezing the firm's accounts and restricting it to trading for liquidation only. That night the firm's clearing FCM issued margin calls that were not met and began liquidating open positions. The next day the CFTC filed its injunctive action and the firm filed its bankruptcy petition. By then approximately 98% of customer futures positions had been liquidated.

This is certainly not the first time that NFA has taken emergency action in a fraud case involving forgery. We issue 8 to 10 Member Responsibility Actions per year, most after detecting some form of fraud, many of them Ponzi schemes. In most cases we uncover the fraud relatively quickly and close the firm before the losses mount too high. In a few cases, though, we have uncovered major frauds involving well over \$100 million. Several of our cases, both large and small, have involved forged bank documents that were identified by our staff. What sets this case apart is that it involves a registered FCM, an elaborate, pervasive and convincing level of forgeries, and worst of all the loss of segregated customer funds.

This most recent case is an extremely painful reminder of the lessons we learned, and have acted on, after MF Global. The following points are clear:

- For our markets to thrive, customers must know that their funds are safe.
- It is the job of the regulators, both government regulators and SROs, to provide the public with the highest level of assurance possible.

- NFA followed audit steps developed by the Joint Audit Committee that were consistent with CFTC Financial and Segregation Interpretation No. 4-1 in all of our examinations of Peregrine. But to assure ourselves of that, a committee of our public directors has directed the commission of an internal review of our audit practices and procedures, and the execution of those procedures in the specific instance of Peregrine.
- Notwithstanding that, and notwithstanding it was NFA's actions that uncovered this fraud in our most recent exam, the simple fact is that Wasendorf's forgeries fooled us, and fooled us for longer than any of us would like.
- Our audit steps alone are not good enough anymore. We are implementing better ways to monitor members for compliance, especially with regard to customer segregated funds, and are looking for even more ways to improve monitoring of firms for compliance with the rules.

Shortly after the demise of MF Global, we formed an SRO Committee with the CME and representatives of other exchanges, including ICE, the Kansas City Board of Trade and the Minneapolis Grain Exchange. As discussed below, the SRO Committee developed a number of rule proposals that have already been approved by our Board. Early on in its deliberations, the committee recognized that we need to make better use of technology to monitor firms for compliance with segregation requirements.

The committee has developed a proposed rule that will be presented at NFA's August Board meeting that would require FCMs to provide online, view-only access to bank balances for customer segregated and secured amount accounts to the firm's designated SRO. We understand the CME will adopt the same rule. Under this rule, SROs will be able to check any customer segregated bank account balance for any FCM any time, without asking the firm or the bank, and compare those balances to the firm's daily segregation report. NFA intends to expand this approach, once it is implemented, to receive daily reports from all depositories for customer segregated accounts, including clearing FCMs. We will develop a program to compare these balances with those reported by the firms in their daily segregation reports. While there may be reconciling items due to pending additions and withdrawals, the system will generate an immediate alert for any material discrepancies.

We have also agreed with the CME to perform an immediate confirmation of all customer segregated bank accounts for all of our FCM Members using the e-confirmation process I referred to earlier. The completion of this work within the next week or so should help ensure that another Peregrine is not lurking in the industry.

All of this is in addition to the rule changes already approved by NFA's Board in May and just recently approved by the CFTC. Those changes include rules requiring that:

- All FCMs must report certain information concerning the FCM's financial condition that will then be made available to the public on NFA's web site. This information includes the firm's capital requirements; its excess capital; the amount of customer segregated funds held by the firm; the amount of excess segregated funds maintained by the firm; whether the firm engages in proprietary trading, once that term is defined in the context of the Volker rule; and whether any custodial bank holding customer funds is an affiliate of the FCM.
- All FCMs must report to NFA detailed information on how customer segregated funds are invested, and that information will also be made available to the public through NFA's web site.
- If any FCM reduces its level of excess segregated funds by 25% in any one day by making disbursements that are not for the benefit of customers, a financial principal of the firm must approve the disbursement, must immediately notify the firm's DSRO, and must certify that the firm remains in compliance with all segregation requirements.

All of these rule changes promote greater transparency for both customers and regulators and should help prevent a recurrence of the type of problems we saw at MF Global. These rule changes, however, are only the beginning. The MF Global and Peregrine customer losses are a painful reminder that we must continuously improve our surveillance, audit and fraud detection techniques to keep pace with changing technology and an ever-more-complicated financial marketplace.

Mr. Chairman, for so long as there have been financial markets, there has been fraudsters who attempt to steal other people's money, and no regulator can provide assurance that fraud can be completely eliminated. But this is the second time in nine months that customers have suffered losses due to misconduct or fraud on the part of an FCM, and when customers suffer those devastating losses, it is also devastating for the industry. We know that we can never completely eliminate fraud, but we must continue to adopt rules and surveillance techniques to try to eliminate the possibility that this could happen again. The steps we took at our May Board meeting and the proposed steps outlined above are a start in that process. We look forward to working with Congress, the Commission and the industry to achieve that goal and no ideas should be off the table in this process.

DANIEL J. ROTH

Daniel J. Roth is President and Chief Executive Officer of National Futures Association (NFA), the premier independent provider of innovative and efficient regulatory programs that safeguard the integrity of the derivatives market. Mr. Roth joined NFA in September 1983 as an Attorney and has held a number of positions with increasing responsibilities, including General Counsel, Executive Vice President and Chief Operating Officer. His tenure as President and CEO began on January 1, 2003.

During the past 29 years at NFA, Mr. Roth has led the organization on major rulemaking and enforcement initiatives, including strengthened anti-fraud rules, that have led to a dramatic drop in customer complaints in the U.S. futures industry. He has developed strong working relationships with international regulators, law enforcement agencies and members of the congressional committees that legislate the financial services industry.

Prior to coming to NFA, Mr. Roth served as Assistant State's Attorney in the Cook County State's Attorney's Office where he was a member of the Official Misconduct Task Force of the Special Prosecutions Bureau. Prior to that, Mr. Roth was an Associate Attorney in general litigation with the law firm of Sidley & Austin.

Mr. Roth holds a law degree from Loyola School of Law and earned his Bachelor of Arts degree in Communication Arts from the University of Notre Dame. He has served as an adjunct professor at the Loyola School of Law and has authored numerous articles for futures industry publications.

Committee on Agriculture
U.S. House of Representatives
Required Witness Disclosure Form

House Rules* require nongovernmental witnesses to disclose the amount and source of Federal grants received since October 1, 2009.

Name: Daniel J. Roth

Organization you represent (if any): National Futures Association

1. Please list any federal grants or contracts (including subgrants and subcontracts) you have received since October 1, 2009, as well as the source and the amount of each grant or contract. House Rules do NOT require disclosure of federal payments to individuals, such as Social Security or Medicare benefits, farm program payments, or assistance to agricultural producers:

Source: None Amount: \$0

Source: _____ Amount: _____

2. If you are appearing on behalf of an organization, please list any federal grants or contracts (including subgrants and subcontracts) the organization has received since October 1, 2009, as well as the source and the amount of each grant or contract:

Source: None (see statement below) Amount: \$0

Source: _____ Amount: _____

Please check here if this form is NOT applicable to you: _____ X

Signature: 

* Rule XI, clause 2(g)(5) of the U.S. House of Representatives provides: *Each committee shall, to the greatest extent practicable, require witnesses who appear before it to submit in advance written statements of proposed testimony and to limit their initial presentations to the committee to brief summaries thereof. In the case of a witness appearing in a nongovernmental capacity, a written statement of proposed testimony shall include a curriculum vitae and a disclosure of the amount and source (by agency and program) of each Federal grant (or subgrant thereof) or contract (or subcontract thereof) received during the current fiscal year or either of the two previous fiscal years by the witness or by any entity represented by the witness.*

PLEASE ATTACH DISCLOSURE FORM TO EACH COPY OF TESTIMONY.

National Futures Association (NFA) is the congressionally authorized self-regulatory organization for the futures industry. NFA performs certain of its regulatory services, for example the registration of industry professionals, on behalf of the CFTC. NFA's funding, however, is provided entirely by the futures industry and NFA has never received any form of compensation from any governmental entity.