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**BEFORE THE COMMITTEE ON FINANCIAL SERVICES
UNITED STATES HOUSE OF REPRESENTATIVES**

***THE FUTURE OF DIGITAL ASSETS: PROVIDING CLARITY FOR THE DIGITAL
ASSET ECOSYSTEM***

JUNE 13, 2023

Chairman McHenry, Ranking Member Waters and Committee members thank you for inviting National Futures Association (NFA) to appear before you today. My name is Thomas Sexton, and I am the President and Chief Executive Officer of NFA. At the outset, we applaud this Committee's and under Chairman Thompson's and Ranking Member Scott's leadership, the House Committee on Agriculture's collaborative work to develop potential legislation governing spot digital assets, including those that are commodities. We strongly believe that retail customers should be protected from wrongdoers engaging in spot digital asset commodity activities and continue to support Congress's efforts to enhance the current regulatory framework to offer greater protections to customers.

Today, I want to discuss the following with this Committee:

- NFA's role and regulatory responsibilities in the derivatives industry;
- NFA's record of success addressing retail trading abuses;
- NFA's strong partnership with the CFTC; and
- NFA's oversight of its Members engaging in spot digital asset commodity activities.

We recognize that this Committee and the House Committee on Agriculture issued a *Discussion Draft* on June 2, 2023 that provides a regulatory framework for digital assets. While we are still fully evaluating the *Discussion Draft*, I thought it may be helpful for us to offer our views about some of the critical customer protections contained in the *Discussion Draft* that Congress should adopt if it moves forward with developing a statutory framework for digital asset commodities.

NFA's Role in the Derivatives Industry

NFA is a registered futures association (RFA) pursuant to Section 17 of the Commodity Exchange Act (CEA), and the industrywide independent self-regulatory organization

(SRO) for the derivatives industry. Our global membership includes CFTC registered futures commission merchants (FCMs), swap dealers (SDs), commodity pool operators (CPOs), commodity trading advisors (CTAs), introducing brokers (IBs), retail foreign exchange dealers (RFEDs) and the registered associated persons of these entities. NFA membership is mandatory as the CFTC requires these registered firms to be NFA Members. We currently have approximately 3,000 Member firms and 42,000 individual Associate Members.

NFA is solely a regulatory body—we partner with the CFTC to regulate our Members' derivatives activities. Further, due to retail customer protection concerns, we have asserted jurisdiction over Members' activities with respect to two specific spot markets—retail forex in the early 2000s and, more recently, digital asset commodities. We do not operate a market nor are we an industry trade association. As a regulator, NFA is a resolute customer protection organization, and we are committed to developing rules and regulatory programs designed to ensure Member firms and industry professionals deal fairly with their customers and counterparties. We are funded by the derivatives industry—primarily from membership dues and an assessment fee on public volume for listed futures contracts. Our FY 2024 operating budget is approximately \$140M and we perform our work with nearly 520 employees. We are headquartered in Chicago, Illinois and have a significant New York City presence.

NFA began operations in 1982 when Congress and the CFTC gave us the responsibility to regulate firms engaging in activities with customers in the exchange-traded derivatives markets. As Congress expanded the CFTC's jurisdiction over the years to include the retail forex spot and swaps markets, Congress and the CFTC also entrusted NFA with additional regulatory oversight responsibilities for these markets.¹ NFA worked very closely with the CFTC to develop rules and regulatory programs to effectively oversee these areas.

NFA's Primary Responsibilities

NFA currently has seven primary functions—registration, rulemaking, monitoring Members, enforcement, market regulation, investor protection and education and dispute resolution. Each are described briefly below:

Registration. Congress via the CEA requires certain firms and individuals that conduct business in the derivatives industry to register with the CFTC. Close to forty years ago, the CFTC delegated its registration responsibilities to NFA. On behalf of the CFTC, NFA registers firms and market professionals after a thorough investigation of their background to determine if they meet specified fitness standards. As part of the registration function, NFA also requires

¹ Congress originally gave the CFTC anti-fraud jurisdiction over the retail forex markets and expanded its jurisdiction to include regulatory oversight in 2008. Congress gave the CFTC jurisdiction over the swaps markets (except for security-based swaps) after the enactment of the U.S. Dodd-Frank Wall Street Reform and Consumer Protection Act in 2010.

associated persons to successfully complete applicable proficiency examinations developed by NFA.

Rulemaking. The essence of self-regulation involves identifying industry best practices in certain areas and then mandating those practices for the entire industry. NFA's Board of Directors reviews and approves the adoption of and changes to all NFA Requirements, which are subsequently subject to the CFTC's review and/or approval. Whether enhancing customer/counterparty protections, addressing fraud, or tailoring rules to specific regulatory issues and markets, NFA has worked with its Members and the CFTC to develop practical and effective regulatory responses for over forty years.² In times of market crisis, NFA's ability to respond quickly and decisively—in weeks not months—to developments is key to restoring or maintaining market participants' confidence.

Monitoring Members. NFA monitors Members for compliance with NFA's rules, which may adopt by reference applicable CFTC regulations, and investigates possible rule violations. Our key monitoring efforts include risk-based examinations, analysis of Members' financial and operational data, the investigation of customer complaints, the review of retail forex trade data, and the review of swap valuation dispute, swap data repository and key market and credit risk data.

Importantly, the CFTC and NFA have rules in place that prohibit customer funds from being commingled with an FCM's proprietary/operating funds. An FCM must maintain in a customer segregated account or accounts money, securities and property in an amount at least sufficient in the aggregate to cover its total obligations to all customers. To further enhance this critical customer protection, NFA and CME Group, Inc. require every FCM to report daily its customer segregated, secured and cleared swap collateral funds' balances, and we also receive daily reports from the depositories holding these funds to ensure that the accounts' balances are sufficient to cover the amount owed to customers.

Enforcement. Adopting stringent rules and monitoring for compliance with those rules does little good if NFA does not vigorously enforce them when appropriate in disciplinary actions against Members.³ NFA's disciplinary panels may impose penalties against Members that include expulsion or suspension from NFA membership, fines, or any other appropriate penalties or remedial actions. Given mandatory membership, a firm or associated person expelled or suspended from NFA membership is effectively barred from the derivatives industry. NFA works

² Further, before implementing a new or amended rule, NFA develops and delivers education to Members to help them understand their regulatory requirements.

³ Over the years, for example, NFA's enforcement efforts have focused on serious types of misconduct including Ponzi schemes, misleading and/or high-pressure sales practices, improper loans and advances from commodity pools, retail forex electronic trading platform manipulative practices, abusive trading strategies and supervisory failures.

very closely with the CFTC's enforcement division so that we can properly coordinate and allocate our regulatory resources, which is critical in emergency situations. Importantly, we also work cooperatively with law enforcement agencies when we observe or suspect criminal activity. Over the years, NFA and the CFTC have brought many cases to quickly close down Ponzi and fraud schemes. Subsequent criminal prosecution of the individuals involved has often resulted in significant prison sentences.

Market Regulation. As permitted by the CEA, NFA's Market Regulation Department performs trade practice/market surveillance functions for certain electronic designated contract markets (DCMs) and Swap Execution Facilities (SEFs). Each SEF and DCM enters into an agreement with NFA to perform these regulatory functions for which they remain ultimately responsible under the CEA.

Investor Protection and Education. Protecting investors has been part of the CFTC's and NFA's mandate since inception and is a critical component of NFA's mission. NFA offers a variety of resources to help investors learn how the derivatives markets work and about the firms and individuals offering investment opportunities in the derivatives markets. We want investors to make informed decisions and avoid dealings with bad actors. Importantly, NFA offers a website tool, BASIC, that investors, the general public and NFA Members can use to research the background of industry professionals.⁴

Dispute Resolution. NFA offers an affordable and efficient arbitration program to help customers resolve futures-related and forex-related disputes with Members.

Addressing Retail Trading Abuses

We recognize that this past year is replete with examples of fraud schemes involving digital asset commodities that have caused significant monetary harm to retail customers. Our experience shows that robust requirements and stringent monitoring that make it difficult for potential fraudsters to carry out their schemes are essential to protect customers.

NFA has a strong track record over the years of closely working with the CFTC to effectively develop regulatory oversight programs targeted to protect retail customers and to prosecute retail trading abuses and fraud. Our collective efforts working with the CFTC, the industry's other SROs and industry participants have yielded significant results—customer complaints and single-event customer arbitrations filed at NFA, as well as CFTC's reparations cases, remain near all-time lows. The following illustrates our commitment to eradicating wrongdoers and protecting retail customers:

⁴ BASIC contains information relating to firms' and individuals' CFTC registration and NFA membership, regulatory actions, FCM financial information and dispute resolution information.

The 1990s—Options Sales Practices

In the 1990s, NFA and the CFTC cracked down on the boiler rooms in South Florida and California that utilized fraudulent sales practices to pitch retail customers on the sale of exchange traded options. These boiler rooms were NFA Member firms that utilized misleading radio and television advertisements to reel in their unsuspecting customers. NFA and/or the CFTC would take an enforcement action and close down one of these firms only to see a related firm open shortly under a new name with many of the same brokers. To address this situation, NFA augmented its sales practice and supervision rules by adopting more enhanced regulatory requirements, which were approved by the CFTC, to make it difficult for these firms to ply their trade.

Specifically, we placed restrictions on Members' use of radio and television advertisements, banned practices that presented a distorted and misleading view of the likelihood of customers earning dramatic profits and those that constituted high-pressure sales. Importantly, if a Member firm had brokers who were previously associated with a firm that had been shut down for sales practice fraud, we imposed enhanced requirements upon it relating to higher capital, tape recording of sales solicitations and the pre-approval by NFA of its promotional material. Therefore, once NFA and the CFTC took enforcement actions, we largely eliminated the incentive for firms to simply reopen under a different name. Due to NFA's and the CFTC's efforts, the large-scale boiler rooms that preyed on retail customers are a thing of the past.

The Early 2000s—Retail Spot Forex

In the late 1990s and early 2000s, an OTC retail forex market aimed at retail customers grew rapidly and many customers were victimized in a completely unregulated market. In the early 2000s, Congress passed legislation providing that off-exchange retail forex transactions were permitted if the counterparty to the retail customer was a regulated entity (*e.g.*, an FCM). As a result, many entities that had no intention of doing on-exchange futures business became registered FCMs solely to act as counterparties to retail forex transactions. These FCMs performed several functions that traditionally had been performed, in part, by separate entities—they solicited customers, accepted customer funds, operated an electronic trading platform via an Internet interface and acted as counterparty (took the other side of the trade) of retail customers. At one point, there were over forty of these firms and fraud and mismanagement were rampant. Even though these firms made up less than 1% of our total Members, they accounted for 20% of our arbitration cases and over 50% of NFA's emergency actions.

Congress gave the CFTC anti-fraud authority over these FCMs' retail forex activities. However, although the firms were CFTC registered FCMs, Congress did not initially give the CFTC authority to regulate these firms' retail forex activities. Equally significant, the CFTC's anti-fraud enforcement efforts were jurisdictionally frustrated with respect to these retail forex transactions after Federal Appeals Courts found that these

transactions were not futures contracts but spot transactions that were outside of the CFTC's jurisdiction.⁵

Although the CFTC's hands were tied both from an anti-fraud and regulatory oversight standpoint, because these FCMs were NFA Members, we were able to step in and fill this regulatory gap until Congress acted in 2008 to give the CFTC the necessary authority. To regulate Members' spot retail forex activities, NFA adopted an anti-fraud provision and rules to establish enhanced capital requirements⁶ and business conduct rules for forex dealers, and we began to weed out the worst offenders. NFA specifically requires, in part, these forex dealers to disclose to customers the risks and inherent conflicts of interest associated with these transactions (e.g., when the customer loses money, the dealer makes money). Moreover, NFA requires forex dealers to inform customers that their customer funds are not segregated and, therefore, are unlikely to be protected in the event of the dealer's bankruptcy. Further, we receive transactional data from these firms' trading platforms to, in part, ensure that retail customers obtain fair prices, and we have taken several enforcement actions against these firms for abusive trading practices.

Due to our continuing customer protection concerns, NFA worked closely with the Congressional Agriculture Committees, the CFTC and the derivatives industry to grant the CFTC the necessary jurisdiction over leveraged spot retail forex transactions. In 2008, Congress amended the CEA to add Section 2(c)(2)(C) to give the CFTC anti-fraud and regulatory jurisdiction over these leveraged spot transactions provided they aren't securities or result in actual delivery within two days.⁷

Given that these spot forex dealers combine several functions⁸ within their business operations, Congress created a new CFTC registration category, Retail Foreign Exchange Dealer (RFED), for firms engaged solely in these spot retail forex transactions. Congress further required these firms to be Members of an RFA. In 2010, the CFTC adopted specific rules to govern spot retail forex transactions, which

⁵ The CFTC brought enforcement actions against several of these firms and lost these actions after federal courts found that these transactions were not contracts of sale of a commodity for future delivery. The courts recognized the leveraged and two-day rolling nature of these transactions but held they were spot contracts after deciding that the retail customers had no guaranteed right of offset and there was allegedly no standardization to the transactions' sizes. Consistent with the CFTC's position, NFA took the position that these transactions were futures contracts.

⁶ Specifically, NFA adopted capital requirements that over a five-year period increased from \$250,000 in 2005 to \$20,000,000 in mid-2009.

⁷ Excluded transactions also include those that create an enforceable obligation to deliver between a buyer and seller that have the ability to deliver and accept delivery, respectively, in connection with their line of business.

⁸ As noted above, these entities solicited customers, accepted customer funds, operated an electronic trading platform via an Internet interface and acted as counterparty (were on the other side of the trade) with retail customers.

extensively mirrored NFA's existing rules. Importantly, when NFA and the CFTC adopted rules in this area, we drew from our experience and the existing regulatory framework for futures intermediaries, making adjustments as needed to address the differences in these markets.

Today, there are four RFED NFA Members.⁹ Over the past several years, they account for very few of our disciplinary and customer arbitration cases.

The Regulation of Spot Digital Asset Commodities

Let me preface my remarks in this area by stating that, as a regulator, NFA does not advocate for specific markets or products and, therefore, will not do so in the case of spot digital assets. Further, our role is not to define what digital assets are securities or commodities.

Our primary responsibility is to regulate our Members' derivatives activities and, in limited instances, their spot market activities (e.g., retail forex and digital asset commodities) when they pose a risk to retail customers. Over five years ago, we had growing concerns with our Member firms engaging in spot digital asset commodity activities and decided to impose requirements upon our Members that have evolved over time in this area.

NFA's Oversight of its Member Firms Engaging in Spot Digital Asset Commodity Activities

Specifically, we were concerned that investors may not fully understand the nature of virtual currencies and virtual currency derivatives, the substantial risk of loss that may arise from trading these products and the limitations of NFA's regulatory authority over spot market virtual currencies. Given these concerns, in 2018, we adopted enhanced disclosure requirements that Members are required to provide customers. Moreover, we required Members engaging in these activities to provide customers with an NFA Investor Advisory – *Futures on Virtual Currencies Including Bitcoin* and the CFTC Customer Advisory: *Understand the Risk of Virtual Currency Trading*.

More recently, NFA extended its jurisdiction over Members' spot digital asset commodity activities. Candidly, we have not observed significant issues with Members engaging in these activities. However, we currently have well over 100 NFA Member firms that reported to NFA that they engage in business activities related to digital assets in the derivatives and/or spot markets. While our rules covered these Members' derivatives activities, they did not generally apply to spot digital asset commodity activities. If an NFA Member firm committed fraud or similar misconduct with respect to its spot digital asset commodity activities, NFA would have been in an untenable position because we would have lacked jurisdiction to prosecute the Member either in an emergency action or disciplinary case.

⁹ Additionally, two FCMs engage in retail forex activities.

Therefore, to proactively ensure that we have jurisdiction to discipline a Member and, in part, regulate Members' activities in this area, we adopted NFA Compliance Rule 2-51. This new rule imposes anti-fraud, just and equitable principles of trade and supervision requirements on NFA Members and Associates engaged in spot digital asset commodity activities. NFA Compliance Rule 2-51 became effective on May 31, 2023 and covers those digital assets that are commodities (e.g., Bitcoin and ether). These two digital assets have related futures contracts listed for trading on CFTC regulated exchanges. If Congress, federal regulators or the courts identify other digital assets as commodities in the future, then NFA would amend the Rule to cover them.

NFA's oversight programs and rules will continue to evolve in this area as we continue to monitor and examine our Members engaged in spot digital asset commodity activities. We recognize, however, that our ability to adopt critical customer protections is limited. We only have jurisdiction over our Members. We cannot create a federal registration and regulatory regime for spot digital asset commodity market participants, including segregated funds and bankruptcy protections for retail customers.

As previously noted, we recognize that this Committee and the House Committee on Agriculture issued a *Discussion Draft* on June 2, 2023 that provides a regulatory framework for digital assets. While we are still fully evaluating this *Discussion Draft*, our initial review found that it contains many of the critical customer protection principles that we believe Congress should adopt if it moves forward with developing this statutory framework for digital asset commodities.

Critical Customer Protections

NFA strongly believes that a customer protection regime for digital asset commodities can be drawn with adaptation from the CFTC's and NFA's foundational rules for exchange traded derivatives and retail forex, as applicable. Congress should provide the CFTC with regulatory authority to complement its current anti-fraud authority over market participants engaged in spot digital asset commodity activities. In doing so, Congress could amend the CEA to adopt a federal registration regime for spot digital asset commodity market participants and trading platforms and provide the CFTC with the authority to adopt critical customer protection rules. As previously noted, the *Discussion Draft* contains many of the key customer protections that we believe Congress should consider if it moves forward with developing a statutory framework for digital asset commodities, including but not limited to:

- Anti-Fraud and Anti-Manipulation;
- Business Conduct Standards (e.g., solicitation and advertising);
- Conflicts of Interest (e.g., prohibitions, management and disclosures);
- Customer Asset Protections (e.g., segregated funds; qualified third-party custodians hold customer assets/property and acknowledge they are

holding customer assets/property; limitations on how customer funds may be invested; and bankruptcy protections);¹⁰

- Disclosures to Customers (e.g., risk of loss, the nature and functionality of digital asset commodities and fees);
- Maintenance of Books and Records;
- Minimum Capital Requirements;¹¹
- Risk Management Procedures; and
- Trade Practice Surveillance (e.g., detect abusive and manipulative trading practices).

These robust customer protections have served the derivatives industry extremely well over the years and will provide digital asset commodity customers with similar regulatory protections, which these customers do not have today. We encourage Congress to allow the CFTC to adopt these critical customer protections if it moves forward with developing a statutory framework for digital asset commodities.

Last, since the *Discussion Draft* proposes a significant role for an RFA, I would be remiss if I did not touch upon the vital role that an independent SRO could assume to partner with the CFTC as it develops a regulatory regime to regulate the digital asset commodity market's participants. For an SRO to operate effectively with the CFTC, two key features are necessary. First, Congress and/or the CFTC must adopt a requirement to mandate membership in the RFA for registrants. As apropos to the derivatives industry, the CFTC has rules requiring mandatory membership in an RFA, which ensures that NFA can discipline, and when appropriate, bar registrants that do not abide by NFA's rules. Without mandatory membership, firms would be able to relinquish their NFA membership if they did not want to follow a rule or were being disciplined for failing to follow NFA's rules. Second, effective government oversight is essential to self-regulation, and this oversight should cover all aspects of the SRO's regulatory activity. Today, while we may partner with the CFTC to regulate our Members, the CFTC closely reviews and monitors our activities to ensure that we fulfill our regulatory responsibilities.

¹⁰ Part 190 of the CFTC's Regulations provides customers with priority in the event of an FCM bankruptcy.

¹¹ An FCM is required to maintain a minimum amount of capital designed to ensure that the FCM has "liquid assets" in excess of the firm's liabilities to provide resources for the FCM to meet its financial obligations as a market intermediary. The CFTC's regulations set forth detailed requirements on how an FCM calculates this amount, which takes into consideration the risks of the FCM's business. FCMs are required to comply at all times with these requirements and notify the CFTC and NFA immediately if they are not in compliance.

Over the years, as Congress expanded the CFTC's jurisdiction to include the retail forex spot and swaps markets, Congress and the CFTC also entrusted NFA with additional regulatory oversight responsibilities for these markets. We have always been willing to take on these additional responsibilities and worked closely with the CFTC to do so. If Congress moves forward with legislation in this area, we stand ready once again to assist the CFTC to the extent requested.

In conclusion, thank you again for the opportunity to appear before you today. We are pleased that this Committee and the House Committee on Agriculture are working collaboratively to develop a regulatory structure to govern spot digital assets, including those that are commodities. We look forward to engaging with this Committee, the House Committee on Agriculture, your Senate counterparts, as well as the CFTC and SEC to create a meaningful regulatory framework with strong customer protections to oversee market participants engaged in the digital asset commodity market.