

**COMMITTEE ON AGRICULTURE, NUTRITION AND FORESTRY  
U.S. SENATE**

**EXAMINING THE FUTURES MARKETS: RESPONDING TO THE FAILURES  
OF MF GLOBAL AND PEREGRINE FINANCIAL GROUP**

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**AUGUST 1, 2012**

Chairwoman Stabenow, Ranking Member Roberts and Members of the Committee, FIA is the leading trade organization for the futures, options and over-the-counter cleared derivatives markets. Our membership includes the world's largest derivatives clearing firms as well as leading derivatives exchanges and clearinghouses from more than 20 countries. Our core constituency consists of futures commission merchants (FCMs), those regulated businesses that transact, guarantee and clear the futures trades of customers and end-users. The FIA's mission since its inception in 1955 has been "to protect the public interest through adherence to high standards of professional conduct and financial integrity..." With that mission in mind, I would like to address the industry's response to the failure of MF Global last October as well as the recent discovery of fraud at Peregrine Financial Group (PFG).

**Peregrine Financial Group**

Three weeks ago, we were made aware that more than \$200 million in customer funds was missing from Peregrine Financial and that the falsification of financial records appears to go back 20 years. On the heels of the MF Global collapse, this is appalling and absolutely devastating news for everyone in our industry, and most of all the customers who are victims of this egregious fraud. PFG was not a big firm, but its demise resonates throughout the industry. Members of the futures industry remain outraged as more becomes known of this extensive fraud carried out on futures customers.

In the futures industry, we took considerable pride in the knowledge that the regulated futures markets had come through the financial crisis of 2008 with relatively few problems. During those difficult weeks, the futures markets continued to operate without significant incident to manage the volatile risk stemming from the financial crisis and to discover transparent prices when confidence was lost in the pricing of the over-the-counter markets. The regulated futures markets, and the regulatory regime that underpins them, became the foundation of mandated swap clearing of Title VII of the Dodd-Frank Act.

We can no longer say that the futures markets came through these times unblemished. The failures of MF Global and Peregrine Financial are a stark and unwelcome reminder that, no matter how well designed a regulatory structure may be, diligent and sustained efforts by regulators and the firms they regulate are essential to prevent losses to customers from mismanagement or fraud.

Peregrine Financial's fraud has had a terribly damaging effect on public confidence in the customer funds protections provided under the Commodity Exchange Act and the Commission's rules. This confidence was earned over decades by the many individuals who comprise the regulated futures industry through their hard work and upright behavior. Unfortunately, one person's conduct has instantaneously shattered this trust and now we all must shoulder the burden of regaining the trust, however long it may take.

At FIA, we understand that it is going to take time to regain public trust and we are committed to doing whatever it takes to restore confidence in the safeguards for customer funds. Doing nothing is not an option.

We also recognize that this is a collective problem, calling for collective solutions. Firms, exchanges, end-users and regulators must work together to identify the additional tools that are needed to protect customer funds and restore confidence and then implement them promptly and efficiently.

### **Post-MF Global Reforms**

The industry and regulators have already taken a number of important steps in the wake of the MF Global collapse to strengthen the customer protection regime in the futures markets. In February, FIA released its Initial Recommendations for Customer Funds Protection, which were prepared primarily by FIA's Financial Management Committee. This committee, which is comprised of senior FCM finance and treasury staff, as well as representatives of depositories, has been meeting regularly since the MF Global bankruptcy to consider enhancements to firm policies and procedures that will further assure customer funds protection. The members of this committee have an exceptional depth of knowledge. They have taken part in several Commission roundtables and can be a tremendous resource for both the Commission and the SROs as they consider additional amendments to their rules.

The FIA recommendations were discussed in detail in our letter to Chairwoman Stabenow in June, a copy of which is included with this testimony for the benefit of the Committee. In brief, FIA called on each FCM to adopt and document – to the extent not already in place – internal control policies and procedures relating to the protection of customer funds. In particular, FIA recommended that FCMs maintain appropriate separation of duties among individuals responsible for compliance with customer funds protections and develop a training program for chief financial officers and other relevant employees to help ensure that the individuals responsible for the protection of customer funds are appropriately qualified. FIA is pleased to see that the CFTC and industry self-

regulatory organizations (SROs) have adopted or are actively considering adopting all of these suggestions.

We also recommended and supported rules recently adopted by the Chicago Mercantile Exchange and National Futures Association that subject all FCMs to enhanced recordkeeping and reporting obligations, including: (i) transmitting daily customer segregation balances to their respective designated self-regulatory organization (DSRO); and (ii) requiring the chief financial officer or other appropriate senior officer to authorize in writing and promptly notify the FCM's DSRO whenever an FCM seeks to withdraw more than 25 percent of its excess funds from the customer segregated account in any day. The Commission has now approved these changes.

Another of our recommendations calls on the Commission to require that each FCM certify annually that there are no material inadequacies in its internal controls regarding maintenance and calculation of adjusted net capital and compliance with the rules regarding the protection of customer funds. FIA encourages the Commission to adopt this recommendation as part of its package of audit improvements.

Clearly, these recommendations for strengthening internal controls are relevant to both MF Global and Peregrine Financial. We have witnessed over the years a number of instances where lax auditing controls or a lack of separation of duties related to the movement and protection of customer money have led to wrongful activity and fraud. The adoption of these basic audit and internal control recommendations will go a long way to detect and deter inappropriate behavior going forward.

FIA also has taken efforts to educate customers on the scope of the protections for their funds so they can make well-informed decisions when choosing where to do business. In February, we issued Frequently Asked Questions on Customer Funds Protections, which is being used by FCMs to provide their customers with increased disclosure on the scope of how the laws and regulations protect customers in the futures markets. This document continues to be updated as we gather comments from regulators on other areas that should be covered. In addition, we will be expanding this document to ensure that customers have material information when evaluating an FCM.

### **FIA's Transparency Initiative**

Even with all that has been done, the recent events involving Peregrine Financial make it evident that more is needed. In this respect, I would like to discuss the "Transparency Initiative" that I announced two weeks back.

First, FIA strongly supports providing regulators with the independent ability to electronically review and confirm customer segregated balances across every FCM at any time.

Second, FIA supports the creation of an automated confirmation process for segregated funds that will provide regulators with timely information that customer funds are secure.

Technology solutions can help prevent this type of event from occurring again and several board members of the FIA participated in last week's CFTC Technology Advisory Committee meeting that discussed technology solutions aimed at better protecting customer funds.

Third, FIA supports the creation of an "FCM Information Portal" that will centrally house firm-specific financial and related information regarding FCMs so customers can more readily access material information when evaluating an FCM. FIA's board is actively considering ways to construct and populate such a system.

Fourth, FIA recommends that FCMs publicly certify as soon as practicable that they are in compliance with the Initial Recommendations for Customer Funds Protection that FIA issued in February, specifically that they have adopted and implemented the internal control policies and procedures related to the protection of customer funds. These controls should be subject to independent review and oversight by the SROs and independent auditors.

Most individual firms have already begun to make efforts to implement these important changes and disclose more information in response to this crisis of confidence, but this effort must be industry-wide and FIA is committed to leading that effort.

In this regard, FIA member firms have been pleased to take part in several forums focused on means to better protect customer funds, including this Committee's staff roundtable in April, several Commission staff roundtables, and the Commission's Technology Advisory Committee last week. We look forward to the Commission staff roundtable on customer protection issues that Chairman Gensler has announced will take place in the second week in August. These forums have generated a number of worthwhile ideas from industry and customer representatives, including my fellow-panelists today, for further protecting customer funds and bringing confidence back to the marketplace. These recommendations deserve careful consideration.

I was encouraged by Chairman Gensler's remarks before this Committee two weeks back that the Commission will be supporting and adopting many of these sensible industry recommendations that I have discussed. The "blocking and tackling" fundamentals of regulation depend on ensuring that firms have proper internal risk controls in place and that these are independently reviewed and verified. Those basics of smart regulation have not changed over time, and we look forward to working with the Commission to prioritize initiatives aimed at protecting customers.

These preventative measures must also be accompanied by strong enforcement when fraud and other illegal conduct are uncovered. The prosecution of these individuals punishes those guilty parties and serves as a powerful deterrent for others tempted to defraud customers. We encourage law enforcement in these instances to vigorously pursue and prosecute these blatant violations of the law.

## **Conclusion**

While an individual bent on fraud can confound even the most sophisticated compliance framework, measures to mitigate the risk of fraud must continue to be vigorously pursued at all levels. The embezzlement at Peregrine Financial appears to have been missed by a generation of regulators at both the federal and self-regulatory levels. But it is going to take a collective effort by these same regulators, as well as the industry whose reputation has been severely damaged by these incidents, to find the necessary solutions to bring customer confidence back to the markets.

There is no easy solution—no magic bullet—that will bring back the trust lost in these past weeks. Instead, it's going to take a lot of hard work across the whole industry to implement a host of improvements to how FCMs conduct their business and how their conduct is examined and audited by the regulators. Better internal controls, more transparency on the movement of funds, independent and more frequent third-party verification of customer balances—those are the starting points for this process, but we are actively seeking out and considering any and all solutions that might contribute to the healing process. I hope today's hearing is the beginning of a constructive, fruitful dialogue with Congress on how to make this industry safer than ever before, and restore your faith in our model for price discovery and risk management. Our customers deserve better and FIA is wholly committed to earning back their confidence and ensuring that customer funds have the highest degree of protections going forward.

Thank you for allowing me to testify.