COMMITTEE ON AGRICULTURE
U.S. HOUSE OF REPRESENTATIVES

OVERSIGHT OF THE SWAPS AND FUTURES MARKETS: RECENT EVENTS AND IMPENDING REGULATORY REFORMS

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Chairman Lucas, Ranking Member Peterson 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 and guarantee the futures trades of customers and end users. All of our membership is working overtime to implement the many reforms in the Dodd-Frank Wall Street Reform and Consumer Protection Act. Significant progress has been made in finalizing these reforms and I will address the rulemaking process later in my remarks. First, however, I would like to focus my remarks on the recent failure of Peregrine Financial Group (PFG).

We now know that more than $200 million in customer funds is missing 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.

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 Group 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.

In addition to the losses suffered by Peregrine's customers, the most damaging consequence of Peregrine's fraud is the effect on customer confidence, in particular in the sanctity of customer funds protections provided under the Commodity Exchange Act (Act) and the Commission's rules. This confidence was earned over decades by the many individuals that comprise the regulated futures industry. Unfortunately, one person's conduct has instantaneously shattered this trust and now overshadows the hard work and honorable behavior of everyone else.

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. These recommendations 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.

We also recommended and supported rules 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. These changes have now been approved by the Commission.

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 must be done. In this respect, I would like to discuss the "Transparency Initiative" that I announced last week.

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.

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.

I was encouraged by Chairman Gensler's remarks before the Senate Agriculture Committee last week that the Commission will be supporting and adopting many of these sensible industry recommendations. 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.

Dodd-Frank Rulemaking

Turning now to Title VII of the Dodd-Frank Act, FIA broadly supports the regulatory goals set out therein, which are designed to implement the G-20 commitment that:

> *All standardised OTC derivative contracts should be traded on exchanges or electronic trading platforms, where appropriate, and cleared through central counterparties by end 2012 at the latest. OTC derivative contracts should be reported to trade repositories.*

As with the regulated futures markets, centralized trading and clearing of swaps will reduce financial and operational risks of all market participants and bring necessary transparency to this critical segment of our financial system.

FIA has been an active participant in the rulemaking process undertaken by the Commission over the past two years, filing more than 50 comment letters and taking part in several Commission staff roundtables. We have also met numerous times with the Commissioners and Commission staff on various issues, which meetings have been reported on the Commission's website.

Our comments have generally been supportive of the regulatory goals, while (i) seeking clarification of the obligations that would be imposed under certain provisions, (ii) noting the operational burdens in complying with others, (iii) raising cost-benefit issues where appropriate, and (iv) recommending alternatives that would achieve the Commission's regulatory goals more effectively and efficiently. Our aim is smarter regulation, not necessarily less regulation.

I should emphasize that our concerns are not limited to swap-related rulemakings. Although the primary focus of Title VII is the over-the-counter swaps markets, the Commission's rules also require FCMs to restructure significantly the way in which they have been conducting their regulated futures businesses for decades and, in the process, to undertake substantial changes to their recordkeeping and reporting systems. Several such rules, discussed below, have posed a significant challenge to both FCMs and the Commission.

Large Trader Reports. In July 2011, the Commission published rules requiring large trader reports for swaps and swaptions on physical commodities, which became effective on September 20, 2011. The rules raised a number of questions for which the industry

sought guidance from the Commission staff. However, it was not until December 2011 that the staff was able to issue a Guidebook that provided additional guidance and detailed instructions for submitting large swaps trader reports to the Commission. In May 2012, the staff issued a revised Guidebook. Because of broad uncertainty surrounding compliance in this area, the Commission staff has found it necessary to issue temporary relief from the large trader reporting requirements five times.

Position Limits and the Aggregation of Positions. The Commission's rules establishing position limits for 28 exempt and physical commodities generally require that, unless a particular exemption applies, a person must aggregate all positions for which that person controls the trading decisions with all the positions for which that person has a 10 percent or greater ownership interest in an account or position, even if the person does not control trading in the other accounts. In May, in response to a petition from the Working Group of Commercial Energy Firms and the Commercial Energy Working Group (Working Groups), the Commission proposed to amend its policy requiring the aggregation of positions. As proposed to be amended, the aggregation policy would permit persons with an ownership that does not exceed 50 percent to file for disaggregation relief, if they can demonstrate independence by meeting Commission-established criteria.

In support of their petition, the Working Groups argued, among other things, that the rules would force information sharing and the coordination of trading between entities that would be contrary to existing best practices for antitrust compliance. Moreover, entities with complex corporate structure arrangements that include established information barriers to ensure compliance with other regulatory requirements would face significant costs to monitor positions on an intra-day basis, notwithstanding the current lack of control over such trading.

FIA supported the Working Groups' petition and is pleased that the Commission has proposed to amend its aggregation policy. Nonetheless, we believe the proposed amendment does not go far enough. The Commission should permit disaggregation without regard to ownership interest when entities can demonstrate separate management and control of trading and positions.

Such a policy is consistent with section 4a of the Act, which calls for aggregation of positions that are subject, directly or indirectly, to common control. Section 4a does not require aggregation of positions arising from common ownership. Such a policy would also recognize commercial reality in an economy in which companies have passive ownership interests in scores, if not hundreds, of companies. Without coordinated trading, there is no increased risk of excessive speculation or manipulation.

A decision on the proposed amendment to the Commission's aggregation policy is only one of several issues on which the industry requires guidance before it can develop the systems necessary to implement the Commission's position limit rules. Other critical open issues include: (i) the scope and logistics of grandfathering existing futures and swaps positions; (ii) the scope of grandfathered risk management positions; (iii) the scope of bona fide hedging transactions; and (iv) the unavailability of technology necessary to

monitor for compliance with position limits intra-day. To date, however, the Commission has not provided a forum for working through these issues, leaving the industry struggling with how it is to comply with this rule.

Legally Separate Operationally Commingled (LSOC) Rules. More recently, the industry has been meeting with representatives of the several derivatives clearing organizations (DCOs) that clear swaps to discuss the operational issues that arise in implementing the Commission's rules for providing protection for cleared swaps customer collateral.

On their face, these rules, commonly referred to as the LSOC rules, appear relatively straightforward and FIA has supported the adoption of this new framework. Each day, clearing member FCMs must provide to the DCOs at which customer positions are carried information regarding (i) the identity of the customers whose positions make up the omnibus account, (ii) the positions carried on behalf of each customer, and (iii) the value of the margin posted with the DCO that supports each customer's portfolio of positions. Nonetheless, a number of very difficult operational questions have arisen that will take time to resolve. Until they are, there is not enough certainty or consensus on certain fundamental issues to permit FCMs and DCOs to build the systems necessary to implement the LSOC rules, which are scheduled to go into effect in November.

Core Principle 9. Certain pending rules also threaten to have a significant impact on the conduct of regulated futures activities. One such rule is the proposed rule implementing Core Principle 9. This principle requires a designated contract market (DCM) to provide "a competitive, open, and efficient market and mechanism for executing transactions that protects the price discovery process of trading in the centralized market." To implement this principle, the Commission has proposed to prohibit a DCM from continuing to list a futures contract unless at least 85 percent of the volume in such contract is traded through the DCM's centralized order book. If a futures contract no longer met the 85 percent test, the DCM would be required to de-list the contract and either liquidate the open positions or transfer the positions to a swap execution facility.

This simple renaming of the instrument from a future to a swap would have dramatic effects, including substantially increasing the amount of initial margin required by the DCO to open the position and changing the tax treatment of the contract for non-hedge positions. Consequently, as we noted in our comment letter on the proposed rule, adoption of the proposed rule would result in significant legal and regulatory uncertainty and would have the curious effect of placing the regulated futures markets at a competitive disadvantage to the cleared swaps markets. In particular, start-up exchanges and new product offerings would find it difficult to meet this litmus test, thus lessening competition and innovation in the industry. Again, this rulemaking was not mandated by Dodd-Frank and its primary aim is the futures markets, not the swaps market where the financial crisis largely stemmed.

Cross-Border Guidance. More recently, the Commission has published for comment what it has termed interpretative guidance on the cross-border application of certain swaps provisions of the Commodity Exchange Act. The interpretative guidance is not a

"rule" under the Administrative Procedure Act and, therefore, does not require the Commission to conduct a cost-benefit analysis before adopting it as final. Although we are still studying its terms, it is evident that the Commission has proposed to adopt a broad interpretation of the definition of a "US person" and of the activities that would be deemed to have "a direct and significant connection with activities in, or effect on, commerce of the United States." The result would be a complex and confusing regulatory scheme that would expose US FCMs and swap dealers to considerable regulatory risk and would effectively extend the CFTC's reach into many jurisdictions around the world. It is imperative that the CFTC clarify this guidance before the registration and other Dodd-Frank requirements go into effect so that firms understand and can plan for the scope of Dodd-Frank's impact on their global businesses.

Implementation Timetable. In light of this complex and legally uncertain regulatory environment, we believe it is essential that the Commission follow the lead of the Securities and Exchange Commission (SEC), which developed and recently published for comment an implementation policy statement. As Robert Cook, the Director of the SEC's Division of Trading and Markets, explained in testimony last week, the policy statement sets out the order in which the SEC expects to require compliance by market participants with the final rules to be adopted under Title VII, with the goal of avoiding "the disruption and cost that could result if compliance with all rules were required simultaneously or haphazardly."

The implementation policy statement divides the final rules to be adopted by the SEC into five broad categories and describes the interconnectedness of the compliance dates of the final rules within each category, and where applicable, the impact of compliance dates of final rules within one category upon those of another category. The statement emphasizes that those subject to the new regulatory requirements arising from these rules will be given adequate, but not excessive, time to come into compliance with them.

This is not a new idea. CFTC Commissioners have urged the Commission to adopt a similar policy statement, as have numerous market participants and trade associations, including FIA. However, time is running out. Unless the Commission acts promptly to establish a well-designed implementation policy, a substantial number of substantive rules will come into effect in the next few months in a haphazard manner, imposing a substantial burden on the industry and exposing the industry to significant risk of enforcement proceedings. In this latter regard, in order to assure that market participants acting in good faith to comply with these rules are not unnecessarily exposed to the threat of enforcement action, it is essential that the Commission provide all market participants with "adequate, but not excessive, time to come into compliance" with these rules.

I want to point out that the challenges that the industry is facing in implementing the Dodd-Frank Act have been exacerbated by the Commission's decision to move forward concurrently with significant rule proposals that are unrelated to the Dodd-Frank Act. I have already mentioned the Core Principle 9 rulemaking, which was not a mandated rule by Dodd-Frank. Another such proposal is the Commission's proposal to require DCMs and other reporting entities to file ownership and control reports (OCR) to the

Commission on a weekly basis. As originally proposed, the OCR rules would have required FCMs to collect and report a substantial amount of information that either is not collected in the manner the Commission anticipated or is not collected at all. As a result, the proposed rules would have required a complete redesign of the procedures, processes and systems pursuant to which FCMs create and maintain records with respect to their customers and customer transactions.

To prepare our comment letter on the proposed OCR rules, FIA formed an OCR Working Group to analyze their potential impact. We found that the median firm would face total costs of roughly $18.8 million and ongoing costs of $2.6 million annually. These costs, combined with the unwarranted structural change in the conduct of business among US futures markets participants that the proposed rules would require, could force a number of FCMs to withdraw from the business and raise the barrier to entry for potential new registrants.

In its comment letter, FIA presented an alternative OCR proposal that we believe would achieve the essential regulatory purposes of the Commission's proposed rules. The cost of the alternative OCR was considerably less than the estimated cost of implementing the OCR rules, but they are substantial nonetheless. FIA and the DCMs continued talking with Commission staff following the comment period. The Commission recently proposed a revised OCR structure that we understand is closer to the alternative that the industry recommended. We look forward to analyzing the proposal.

We must emphasize that the FIA alternative was not developed within the 60-day comment period originally proposed by the Commission. It took several months of detailed analysis by industry representatives who otherwise perform critical operational and risk management responsibilities in their firms. We also want to emphasize that the OCR rule exemplifies a broader problem; the firms are being overwhelmed with the volume and complexity of the record-keeping and reporting programs they are being asked to implement in a very short time frame.

Another rulemaking not directly mandated by Dodd-Frank is the Commission's recent adoption of rule 1.73 requiring clearing member FCMs to establish risk-based credit limits for all customers and implement procedures to screen all orders for compliance with these limits prior to execution. In particular, an FCM would be required to screen by automated means all orders received or executed by automated means. However, no systems currently employed by, or available to, clearing member FCMs, or the DCMs on which the trade may be executed, permit a trade to be screened prior to execution for its potential effect on the customer's existing portfolio of positions. Risk management systems are designed to monitor a customer's risk on a post-execution/post-cleared basis. Moreover, the rule appears to require significant changes in the operational and contractual relationships among clearing member FCMs, executing brokers and investment managers as well as substantial systems changes.

FIA is requesting the Commission staff to clarify the intended scope of the rule, and we are hopeful that the staff will approve an interpretation of the rule that will be technologically practicable, while meeting the Commission's regulatory goals.

Conclusion. These are challenging and difficult times for our industry, not only due to the regulatory changes described above but also due to fundamental shifts in the business model that underlies the futures industry. With depressed futures volumes, historically low interest rates, and an ultra-competitive pricing model, FCMs are under tremendous strain financially. Many are concerned that the business is reaching a point where it cannot absorb additional costs without a seismic shift in the model—whether that is significant consolidation among FCMs or FCMs leaving the business altogether. This would have the unfortunate effect of limiting customer choice and reducing the number of firms that backstop the clearing system, making it more vulnerable to catastrophic losses. So as we consider regulatory changes, it would be wise to carefully weigh the costs of any new regulatory mandates and concentrate our resources on implementing the highest priority reforms ahead of all the rest.

As discussed above, the industry is working against a short deadline while faced with considerable uncertainty about how the Commission plans to implement a wide swathe of its rules and how those rules will fit in a global regulatory structure. As we move forward, it is essential that the unintended consequences of any reforms be eliminated and the many positives that this industry has delivered to the customers of our markets be preserved.

Thank you and I will be happy to answer any questions.

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Walt Lukken is the President and Chief Executive Officer of the Futures Industry Association, a Washington, D.C.-based trade association that represents participants in the regulated, listed and cleared derivatives markets. The FIA's membership includes the world's largest derivatives clearing firms as well as leading derivatives exchanges and clearinghouses from more than 20 countries. The FIA serves to uphold fair and competitive markets, protect the public interest through adherence to high standards of professional conduct and financial integrity, and promote public trust and confidence in the regulated markets for listed and cleared derivatives.

Walt previously was Chief Executive Officer of New York Portfolio Clearing, the capital-efficient derivatives clearinghouse jointly owned by NYSE Euronext and the Depository Trust and Clearing Corp. Under his leadership, NYPC successfully launched the unprecedented "one-pot" margining of interest rate futures cleared by NYPC with fixed income cash positions cleared by DTCC's Fixed Income Clearing Corporation. NYPC's achievement was awarded the 2011 "Best Innovation by a Clearinghouse, North America" by Futures and Options World.

Before joining the private sector in 2009, Walt served as Acting Chairman of the Commodity Futures Trading Commission for 18 months, a period that included the financial crisis of 2008, and as CFTC Commissioner since 2002. In this role, he testified numerous times before Congress and served as a Principal on the President's Working Group on Financial Markets with Treasury Secretary Hank Paulson, Federal Reserve Chairman Ben Bernanke and Securities and Exchange Commission Chairman Christopher Cox. He represented the CFTC before international organizations and forums, including the International Organization of Securities Commissions. From 2003 to 2008, he served as Chairman of the CFTC's Global Markets Advisory Committee—an industry-comprised body that advises the Commission on issues affecting cross-border regulation, trading and markets.

Prior to joining the CFTC, Walt served for five years as counsel on the professional staff of the U.S. Senate Agriculture Committee under Chairman Richard Lugar. He specialized in futures and derivatives markets and was prominently involved with the passage of the Commodity Futures Modernization Act of 2000. He received his B.S. degree with honors from the Kelley School of Business at Indiana University and his Juris Doctor degree from Lewis and Clark Law School in Portland, Oregon.

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: Walter L. Lukken

Organization you represent (if any): Futures Industry 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: _____ Amount: _____

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: _____ Amount: _____

Source: _____ Amount: _____

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

Signature: Walt Lukken

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