

**HOUSE COMMITTEE ON AGRICULTURE**  
**UNITED STATES HOUSE OF REPRESENTATIVES**  
**THE FUTURE OF THE CFTC: MARKET PERSPECTIVES**

**STATEMENT OF WALTER L. LUKKEN**  
**PRESIDENT AND CHIEF EXECUTIVE OFFICER**  
**FUTURES INDUSTRY ASSOCIATION**

**May 21, 2013**

Chairman Lucas, Ranking Member Peterson and members of the Committee, thank you for the opportunity to provide our perspective on matters affecting the derivatives industry and in particular the regulation of our markets by the Commodity Futures Trading Commission (CFTC). As you turn your attention to reauthorizing the CFTC, the Futures Industry Association (FIA) stands ready to assist in any way we can. FIA is the leading trade organization for the futures, options and over-the-counter cleared derivatives markets. It is the only association representative of all organizations that have an interest in the listed derivatives markets. Its membership includes derivatives clearing firms, traders and exchanges from more than 20 countries. FIA's core constituency consists of futures commission merchants, commonly known as FCMs, and the primary focus of the association is the global use of exchanges, trading systems and clearinghouses for derivatives transactions.

As you know, clearing has long been an integral part of the futures market structure. Clearing ensures that parties to a transaction are protected from a failure by the opposite counterparty to perform their obligations, and the FCMs that FIA represents play a critical role in ensuring that transactions are secured with appropriate margin to facilitate this clearing process.

**Improving Customer Protection**

I would like to take this opportunity to update the Committee on recent efforts to improve the handling of customer funds, or what is often called margin or collateral. As you know, the failures of MF Global Inc. and Peregrine Financial Group resulted in severe and unacceptable consequences for futures customers and the markets generally. The entire industry has been

working collaboratively to identify and improve procedures required to better protect the integrity of these markets. A number of changes are already being implemented, many of which were recommended by FIA in the aftermath of these insolvencies<sup>1</sup>:

- The National Futures Association (NFA) and the CME Group (CME), the industry's principal self-regulatory organizations, have adopted rules that subject all FCMs to enhanced recordkeeping and reporting obligations. For example, chief financial officers or other appropriate senior officers are now required 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 are funds deposited by the FCM into customer segregated accounts to guard against customer defaults.
- NFA and CME have begun building an automated system for the daily monitoring of all customer segregated, secured, and cleared swaps amounts held by FCMs. As part of this project, NFA and CME contracted with AlphaMetrix360, a subsidiary of AlphaMetrix Group, to aggregate the data on customer segregated, secured, and cleared swaps amount accounts. The new system will allow NFA and CME to run an automated comparison of the balances in customer segregated, secured, and cleared swaps accounts at the depositories with the daily reports they receive from FCMs, and then quickly identify any discrepancies.
- NFA is also collecting additional financial information from FCMs and posting that information on its online Background Affiliation Status Information Center (Basic) system, a key step in giving customers the tools they need to monitor the assets they deposit with their FCMs. The new service provides the public with access to specific

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<sup>1</sup> See Futures Industry Association, Futures Markets Financial Integrity Task Force - Initial Recommendations for Customer Funds Protection:

[http://www.futuresindustry.org/downloads/Initial\\_Recommendations\\_for\\_Customer\\_Funds\\_Protection.pdf](http://www.futuresindustry.org/downloads/Initial_Recommendations_for_Customer_Funds_Protection.pdf)

information about an FCM, such as the firm's adjusted net capital, the amount of funds held in segregated, secured, and cleared swaps accounts, and the types of investments that the FCM is making with those customer funds.

- It is my understanding that NFA is in the process of drafting an interpretive notice that contains specific guidance and identifies the minimum required standards for FCM internal controls such as separation of duties; procedures for complying with customer segregated and secured amount funds requirements; establishing and complying with appropriate risk management and trading practices; restrictions on access to communication and information systems; and monitoring for capital compliance.
- A set of frequently asked questions on customer funds protection<sup>2</sup> has also been developed by FIA, 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.
- Additionally, FIA, CME Group, NFA, and the Institute for Financial Markets have partnered to fund an evaluation of the costs and benefits of various asset protection insurance proposals. We look forward to sharing these findings with the Committee when available.

In addition to the efforts undertaken by the industry, the CFTC has recently proposed a set of comprehensive regulations to further enhance customer protection. To a significant extent, the proposed rules build upon and codify the recommendations that FIA made and rules that the NFA and CME adopted in early 2012. FIA strongly endorses the regulatory purposes underlying the proposed amendments. We nonetheless submitted an extensive comment letter designed, in substantial part, to assist the Commission in striking an appropriate balance among its

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<sup>2</sup> See Protection of Customer Funds, Frequently Asked Questions:  
<http://www.futuresindustry.org/downloads/PCF-FAQs.PDF>

several proposals to assure that the producers, processors and commercial market participants that use the derivatives markets to manage the risks of their businesses will be able to continue to have cost-effective access to the markets and a choice of FCMs. In particular, the proposed change related to residual interest drastically re-interprets the long-standing application of the statute and will result in a tremendous drain on liquidity that will make trading significantly more expensive for customers hedging their financial or commercial risks, and will adversely affect the ability of many FCMs to operate effectively. The current interpretation was essential to the performance of the futures industry during the 2008 crisis and its application is not related to the shortcomings identified after the recent failures. When the proposal was released the Commission did not have adequate information to determine the costs of the modified residual interest requirement<sup>3</sup>. As such, FIA engaged an accounting consultant to sample FCMs on the potential costs of the residual interest proposal; the results show that this change could require an additional \$100 billion obligation to the customer funds accounts, beyond the sum required to meet initial margin requirements. Many of the very customers this proposal is designed to benefit have expressed concerns as they rightfully realize this will significantly increase the costs of hedging and likely have the largest impact on small to mid-sized FCMs which could potentially lead to consolidation and fewer choices for them as customers. As previously mentioned, the FIA supports many of the customer protection measures that the Commission has proposed, we simply believe this one in particular warrants further review as to why the existing statutory interpretation should be changed.

The FIA is very engaged in the development of industry and Commission-initiated efforts to proactively address many of the issues presented by these recent failures. While the derivatives industry is strong, and clearing continues to be the gold standard in protecting market participants from the unexpected failure of a counterparty, we have learned that the collateral necessary for a robust clearing system, and the customers who post such margin, are better protected through enhanced disclosures, reporting, and internal controls. Our members commit a substantial amount of their own capital to guarantee customer transactions. We

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<sup>3</sup> See 77 FR 67916

have every incentive to ensure that the integrity of the derivatives clearing system is well-regarded as safe and reliable.

### **Clearing Under the “Dodd-Frank Act”**

Under the “Dodd-Frank Act”, Congress determined to extend clearing beyond futures to swaps, and as such the role of the FCM has also expanded. Because FCMs play a critical role in achieving the newly-established clearing regime for swaps, we are happy to offer our thoughts on the implementation of these requirements.

To date, much of the debate surrounding the implementation of the swaps clearing requirements under the “Dodd-Frank Act” has been focused on who, what, when and where, rather than how. Often, public attention to Title VII implementation has been devoted to what products will be subject to the clearing mandate; who will be expected to comply with the mandate; when they will be expected to comply; and where, within the global markets, the products and participants will be regulated – all very important questions, but far less discussion has been devoted to how the mechanics of clearing are being impacted. This is probably a result of the fact that as the legislation was being constructed there were very few questions about how the actual act of clearing swaps would work – I believe most assumed that the process already established for futures would simply be applied to swaps. Certainly, the regulatory policies that have historically existed for clearing futures can largely be applied to swaps, with the occasional exception necessitated by the fact that swaps and futures have evolved in different environments. Unfortunately, the reality is that the rules being written to facilitate the clearing of swaps are in some cases re-inventing the already proven clearing process that is familiar and tested for futures, thereby creating an overly-complicated web of regulations for both swaps and futures. Even those who have for many years operated within the existing futures clearing environment are being forced to seek temporary relief from the new regulations while they sort through compliance options. Without such relief, market participants face the reality of either shutting down existing commercial activity or inadvertently being out of compliance as they seek to implement confusing regulations.

Also of concern is the manner in which the needed relief is being granted. Relief is commonly provided at the very last minute causing disruptions for customers in both the futures and the swaps markets and causing tremendous resources to be wasted while market participants prepare and wait.

While the industry appreciates the opportunity to seek temporary relief in these circumstances, what necessitates this relief and the manner in which the relief is granted remain troubling. Let me be clear, we support properly designed and effective clearing rules. Our members provide the majority of the funds that support derivatives clearinghouses and commit a substantial amount of their own capital to guarantee customer transactions. We have every incentive to ensure that the actual process of clearing derivatives – both futures and swaps – is properly regulated.

However, at this critical juncture, when the newly required clearing mandate for swaps is beginning to take effect, we are concerned that so much complexity and disorder exists especially given the existence of rules that have long governed the clearing of futures. FCMs stand ready and willing to facilitate the clearing of swaps, just as they have for futures, but the wide-spread confusion as to the mechanics of clearing under these new regulations may be hindering the process.

### **State of the Derivatives Industry**

I want to take some time to update you on the general state of the derivatives industry. As the swaps market developed and Congress, through the “Dodd-Frank Act”, determined that certain swaps are now likely suitable for the clearing protections that have long been required for futures, some have claimed that there is regulatory arbitrage occurring, with futures and swaps competing against each other. I believe that most market participants welcome the broadened array of products available in a cleared environment and will continue to use both swaps and futures products to meet their individual risk management needs as appropriate. And as these

products continue to evolve, so will their demand. That is the nature of the derivatives industry which has long been dynamic.

In 2012, the total number of futures and options contracts traded on exchanges worldwide dropped by 15.3%. However, overall trading and clearing volumes have risen over the past 10 years. Even before the clearing mandate for certain swaps and swap market participants took effect in March, the volume of swaps submitted voluntarily for clearing was up in January:

- LCH.Clearnet experienced a major surge in interest rate swap clearing, with volume exceeding \$55 trillion in notional value in January, an all-time high.
- CME Group also saw all-time highs in interest rate swap clearing, with January volume of more than \$250 billion notional cleared and \$750 billion in open interest.
- The notional volume of credit default swaps cleared by ICE Clear Credit totaled \$400 billion in January.

As the clearing mandate took effect in March for swap dealers, major swap participants and active funds the infrastructure responded relatively well – as noted many of these entities had been engaged in voluntary clearing efforts prior to the March date. It should be noted that the next effective date of June 10 will bring in many more participants and will likely present many more challenges to the new regulatory regime. Given the timing, these implementation challenges will likely become apparent and coincide with the Committee’s consideration of the CFTC reauthorization – I encourage you all to continue your long-standing tradition of bipartisan oversight as you focus on these issues absent political pressure.

I am fortunate to represent a wide array of stakeholders in the derivatives industry – all of whom want to see this industry continue to support the risk management needs of its customers in a productive way. This is a goal I know the members of this Committee share and I look forward to working with you as you consider the CFTC’s role in achieving this mutual objective.

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, 2010.

Name: Walt 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, 2010, 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, 2010, 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: XXX

Signature: Walt Lukken

\* 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.





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**Walt Lukken**

*President and Chief Executive Officer  
Futures Industry Association*

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  
Information Required From Nongovernmental Witnesses

House rules require nongovernmental witnesses to provide their resume or biographical sketch prior to testifying. If you do not have a resume or biographical sketch available, please complete this form.

1. Name: Walt Lukken
  
2. Organization you represent: Futures Industry Association
  
3. Please list any occupational, employment, or work-related experience you have which add to your qualification to provide testimony before the Committee: \_\_\_\_\_  
\_\_\_\_\_  
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4. Please list any special training, education, or professional experience you have which add to your qualifications to provide testimony before the Committee: \_\_\_\_\_  
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5. If you are appearing on behalf of an organization, please list the capacity in which you are representing that organization, including any offices or elected positions you hold: President and Chief Executive Officer  
\_\_\_\_\_  
\_\_\_\_\_

PLEASE ATTACH THIS FORM OR YOUR BIOGRAPHY TO EACH COPY OF  
TESTIMONY.