TESTIMONY OF GARY GENSLER

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BEFORE THE

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

WASHINGTON, DC

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Good morning Chairwoman Stabenow, Ranking Member Roberts and members of the Committee. I thank you for inviting me to today's hearing on the recent events related to Peregrine Financial Group. I'm pleased to testify along with my fellow Commissioner Jill Sommers.

Peregrine Financial Group, Inc.

Background

On July 10, the Commodity Futures Trading Commission (CFTC) filed a complaint in federal court against Peregrine and its sole owner, Russell Wasendorf, Sr., alleging that they misappropriated customer funds from an account held at US Bank.

Criminal authorities arrested Mr. Wasendorf for lying to the CFTC, and they advised the court that they intended to file more criminal charges in the future.

The CFTC's complaint, along with the criminal charges, tells a story of deliberate dishonesty and deception. In a written statement found when he attempted suicide, as quoted in the criminal charges, Mr. Wasendorf said he committed fraud, manufactured phony bank documents, and forged bank signatures. In short, the charges against him are that he took customers' funds right out of the bank, and lied about it for years.

The System of FCM Oversight

Peregrine is a CFTC-registered Futures Commission Merchant (FCM). The National Futures Association, a futures industry self-regulatory organization, is responsible for the firm's front-line oversight. The way our oversight system has been set up for decades, SROs are the primary regulators of FCMs, introducing brokers, commodity pool operators, and commodity trading advisors. In 2000, Congress affirmed the Commission's reliance on SROs by amending Section 3 of the Commodity Exchange Act to state: "It is the purpose of this Act to serve the public interests . . . through a system of effective self-regulation of trading facilities, clearing systems, market participants and market professionals under the oversight of the Commission." Further, based on this system and the realities of limited CFTC resources, in the wake of the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act), the NFA also will take on additional examination and registration duties with regard to swap dealers.

As part of its oversight responsibility, the NFA is required to conduct periodic audits of non-clearing member FCMs' customer funds in segregated and secured accounts. The CFTC oversees the NFA, examining them for the performance of their duties. We do such

examinations on a periodic basis, usually looking at one of these significant areas: the NFA's FCM examination program, sales practices, disciplinary programs, monthly financial statement reviews, and the NFA's training and staffing levels. Prior to 2008, the CFTC only infrequently reviewed the NFA's FCM examination program. More recently, the CFTC has moved to a quarterly review of the NFA's FCM examination program in which the agency selects a small sample of the NFA's FCM work papers to review. Recent CFTC examinations of the NFA included recommendations for clearer documentation of audit procedures, enhanced training and supervisory review procedures, and establishing requirements for the filing of amended financial statements. In addition, the CFTC also does limited-scope reviews of FCMs in a "for cause" situation that are sometimes referred to as "audits," but they are not full-scale audits as accountants commonly use that term.

Under CFTC rules, FCMs must have their annual financial statements audited by an independent CPA using Generally Accepted Auditing Standards. As part of this certified annual report, the independent accountant also must conduct appropriate reviews and tests to identify any material inadequacies in systems and controls that could violate the Commission's segregation or secured amount requirements. Any such inadequacies are also to be reported to the SRO and the Commission.

The Oversight of Peregrine

The NFA last completed an audit of Peregrine in May 2011, and was in the process of conducting another periodic audit over the last several weeks. Peregrine's financials for the year

ending December 31, 2011, were reviewed and certified by its independent CPA expressing a clean opinion on both the financial statements and internal controls report.

In 2000, the CFTC brought an enforcement action against Peregrine, finding in an Order that the firm had violated net capital rules. At the time, Peregrine was much smaller than it was in 2012, with roughly $800,000 in net capital requirements and $23 million in customer segregation requirements. The firm was ordered to pay a civil penalty and to take steps to improve its financial controls, including retaining a second independent public accounting firm to perform reviews of certain financial accounts and to report its findings to the CFTC. The firm retained PricewaterhouseCoopers.

The CFTC's Order in 2000, resolving the enforcement investigation, was the culmination of a process that began with limited-scope reviews conducted by the CFTC examinations staff in the 1990s. During these reviews, the staff noted a number of problems at Peregrine regarding, among other things, net capital, infusions of capital to avoid net capital violations, internal financial controls, and records of segregated and secured customer assets and liabilities. Other issues related to accounting for receivables and payables; transactions and agreements with affiliates; differences between journal entries on the company's books and the statements of one of its banks, Harris Bank; accuracy of books and records; the abilities of the firm's auditor; and providing customers with timely trade confirmations and monthly statements. In addition, CFTC staff questioned whether Peregrine had tried to mislead them concerning some of these accounting issues. The staff also noted issues regarding the sufficiency of NFA audits.

Subsequently, in 2007 and 2008, the CFTC examinations staff reviewed Peregrine's classification and reporting of customer-owned securities and the investment of customer funds for compliance with CFTC Regulations. The limited reviews identified improperly titled segregation bank accounts, which were corrected during the examination. In addition, the staff in 2010 performed a limited, two-day review of Peregrine's anti-money laundering compliance.

Although we do not yet know the full facts of what happened in this matter, it is clear that the system failed to protect the customers of Peregrine. The NFA and CFTC staff over the years did not detect Mr. Wasendorf's alleged stealing of customer funds, which came to light only a few weeks ago. Though the local police cannot prevent every bank robbery and market regulators cannot prevent every financial fraud, we all must do better. We must do everything within our authorities and resources to strengthen oversight programs and the protection of customer funds.

Customer Protection

CFTC Customer Protection Reforms to Date

The Commission has been actively working to improve protections for customer funds. This includes:

- The completed amendments to rule 1.25 regarding the investment of funds bring customers back to protections they had prior to exemptions the Commission granted

between 2000 and 2005. Importantly, this prevents use of customer funds for in-house lending through repurchase agreements;

- Clearinghouses will have to collect margin on a gross basis and FCMs will no longer be able to offset one customer's collateral against another and then send only the net to the clearinghouse;
- The so-called "LSOC rule" (legal segregation with operational comingling) for swaps ensures customer money is protected individually all the way to the clearinghouse; and
- The Commission included customer protection enhancements in the final rule for DCMs. These provisions codify into rules staff guidance on minimum requirements for SROs regarding their financial surveillance of FCMs.

In addition, last month, we approved an NFA proposal that stemmed from a coordinated effort by the CFTC, the SROs, and market participants, including from the CFTC's two-day roundtable earlier this year on customer protection.

The three key areas of reform included in the NFA rules are:

- First, FCMs must hold sufficient funds in Part 30 secured accounts (funds held for U.S. foreign futures and options customers trading on foreign contract markets) to meet their total obligations to customers trading on foreign markets computed under the net liquidating equity method. FCMs will no longer be allowed to use the alternative method, which had allowed them to hold a lower amount of funds representing the margin on their foreign futures;

- Second, FCMs must maintain written policies and procedures governing the maintenance of excess funds in customer segregated and Part 30 secured accounts. Withdrawals of 25 percent or more of excess funds in these accounts (that are not for the benefit of customers) must be pre-approved in writing by senior management and reported to the NFA; and
- Third, FCMs must make additional reports available to the NFA, including daily computations of segregated and Part 30 secured amounts, as well as twice monthly detailed information regarding the cash deposits and investments of customer funds.

CFTC Restructuring and Enforcement

The CFTC also has implemented a significant restructuring, based on a new strategic plan, regarding our oversight of SROs and intermediaries.

The CFTC last year established a new division dedicated solely to the oversight of the SROs and intermediaries. We created a branch within the division to specifically oversee examinations. We were able to attract talented individuals from the private sector with many years of relevant experience to lead this new division and branch. We have begun the process of strengthening our examination program, including adding risk and control elements. Separately, we also recently created a Consumer Outreach Office to help consumers get information about avoiding fraud.

In addition, the CFTC's enforcement arm aggressively pursues bad actors in the markets. In the last two years, the Division of Enforcement has been filing cases and opening investigations at the highest rate in the CFTC's history. Roughly half of the cases involve fraud against customers.

Since October 2009, the CFTC has brought 22 cases against registered FCMs, 13 of which involved supervision failures and one of which involved a failure to maintain customer secured funds properly. In the same period, the CFTC brought two cases in federal court against FCMs, one for violating segregation rules and the other for failing to be properly capitalized and to maintain books and records.

The Commission in April charged JPMorgan Chase Bank, N.A. for unlawful handling of Lehman Brothers, Inc.'s customer segregated funds and imposed a $20 million civil monetary penalty. In another case against a public accounting firm and a CPA partner of the firm, the Commission imposed sanctions for failing to conduct proper audits of a registered FCM. In one of our supervision failure cases, a registered FCM was sanctioned for failing to follow its own compliance procedures regarding "know your customer" requirements.

Customer Protection Reforms Ahead

While the Commission's enhanced customer protection rules, staff reorganization and enforcement efforts to date have been significant, I believe we must do more. I believe we need to further enhance the agency's rules for customer protection. As outlined below, staff

recommendations, based on substantial commissioner and market participant feedback, are now drafted and in front of commissioners.

First, we must incorporate the NFA rules approved last month into the Commission's regulations so that the CFTC can directly enforce these important reforms.

Second, I believe it is critical that we bring the regulators' view of customer accounts into the 21st century. We must give the SROs and the CFTC direct electronic access to FCMs' bank and custodial accounts for customer funds, without asking the FCMs' permission. Further, acknowledgement letters (letters acknowledging that accounts contain segregated customer funds) and confirmation letters must come directly to regulators from banks and custodians.

Third, I believe we need more transparency to customers about their funds. Futures customers, if they wish, should have access to information about how their assets are held and with whom, similar to that which is available to mutual fund and securities customers.

Fourth, I believe we need to consider enhanced controls at FCMs regarding how customer accounts are handled.

In addition, I believe we need to carefully consider additional rules laying out the SROs' requirements for conducting examinations and audits.

Regarding the Commission's oversight of SROs and intermediaries, though we're making progress through our reorganization and new rules, the recent events at Peregrine highlight the necessity of looking at the decades-old system of SROs and the Commission's role in overseeing SROs.

I have directed the CFTC's staff to do a full review of how the agency conducts oversight of the SROs, as well as limited scope reviews of FCMs, to determine what improvements can and should be made. As part of this review, we have reached out to the Public Company Accounting Oversight Board (PCAOB), which oversees the audits of public companies. The Dodd-Frank Act gave the PCAOB oversight authority over the audits of brokers and dealers who are registered with the Securities Exchange Commission. The PCAOB has agreed to give us the benefit of its insights and expertise.

Last week, the CFTC held a Technology Advisory Committee meeting to examine how technology can be incorporated as a tool for customer fund verification. Building on the customer protection public roundtable earlier this year, I also have asked CFTC staff to hold another public roundtable discussion on customer protection issues, including examination techniques and procedures, which will take place during the second week of August.

Resources

Confidence in the futures and swaps markets is dependent upon a well-funded regulator. The CFTC is a good investment of taxpayer dollars. This hardworking staff of 710 is just 10

percent more than what we had at our peak in the 1990s though the futures market has grown fivefold. The CFTC also will soon be responsible for the swaps market – eight times bigger than the futures market.

The Commission's limited resources have historically not allowed for direct oversight of FCMs. There are 46 staff members, including 35 audit staff, on the CFTC's examinations team who oversee four SROs, which in turn have responsibilities for more than 4,341 registered persons. On top of the current lack of staff for examinations, our responsibilities are expanding to include reviews of many new market participants. For instance, there are currently 115 FCMs, and staff estimates a similar number of swap dealers will ultimately register. More frequent and in-depth risk-based, control-oriented examinations are necessary to assure the public that firms have adequate capital, as well as systems and procedures in place to protect customer money. Greater coverage by regulators – like having more cops on a beat – will improve the integrity and heighten the deterrent effect of the review process.

The President's FY2013 budget, following a similar request in 2012, asked for $308 million, investing in our technology and human resources, to better protect the public.

Market participants depend on the credibility and transparency of well-regulated U.S. futures and swaps markets. Without sufficient funding for the CFTC, the nation cannot be assured that the agency can adequately oversee these markets.

Thank you and I look forward to your questions.