

The case for smart regulation – The futures industry between Dodd- Frank and the aftershock of MF Global

Every era has its market turbulences or at worst crashes. In such times the pendulum of regulation is in full swing. Where do we stand on the regulatory front? – John Damgard and Walt Lukken, immediate past president of the FIA and his successor, answer the questions of Otto E. Nägeli and Werner Vogt.

John Damgard, you were at the helm of the FIA for 30 years. When you think about difficult moments, what comes to your mind first?

Damgard: The crash of Barings Bank in 1995 and the terrorist attack on 9/11 certainly rank among the most difficult events that occurred during my time at the FIA. In both cases our task was to lead the industry response, and I am proud to say that we rose to the challenge and brought our members together in a very effective way.

The stock market crash of October 1987 was also a very difficult moment, but in that case the real challenge was to fend off the attacks from politicians who wanted to blame the futures industry for everything that went wrong. Back in those days, Washington viewed our industry with great suspicion, and I think when history looks back at our achievements, I think one of the biggest is that today there is much greater respect and understanding of our markets and the benefits we provide to investors, corporate hedgers, and the economy as a whole.

You have seen generations of traders come and go. What has struck you most in those 30 years?

Damgard: The futures industry has grown and developed at an enormous pace. When I started at the FIA back in 1982, the business was limited to futures based on a handful of physical commodities. Today we've grown far, far beyond that. The basic concept has been adapted and applied to hundreds of financial instruments and new markets have been established in almost every corner of the globe. To have witnessed these extraordinary changes from such a privileged vantage point has been an absolutely fascinating experience, and now I'm delighted to give the same opportunity to Walt Lukken. As the former head of the Commodity Futures Trading Commission and as the former chief executive officer of a clearinghouse, he is the ideal choice to lead the FIA in this new era of regulatory reform.

Walt Lukken, how would you describe the development of the futures and options industry during the period as Commissioner of the CFTC?

Lukken: Let me start by paying tribute to my predecessor John Damgard. He has been absolutely crucial in furthering the interests of futures industry here in Washington and around the

world. I spent about seven years at the CFTC, first as one of five Commissioners and then as Acting Chairman in 2007 and 2008. That was a very busy period of time marked by the demutualisation of the exchanges, an accelerating revolution in technology, and increased competition among exchanges and alternative trading facilities. As John has said many times before, competition is good for this industry, and I expect that in the years ahead we are going to see competition continue at a very high level and maybe even intensify.

Walt, with the effects of the financial crisis barely digested we have recently witnessed the failure of MF Global. Where do we stand in the field of upcoming regulation?

Lukken: As you know both Europe and the U.S. are deeply engaged in the implementation of major reforms to the financial markets infrastructure. What makes MF Global especially important in this context is that it challenges one of the basic assumptions of those reforms, which is that exchange trading and central clearing are the solutions for the problems we saw in the over-the-counter derivatives markets. After 150 years during which the futures industry was proud to say that no customer funds were ever lost because of a default, we now have a case where exactly

this happened. The protection of customer funds has to be sacrosanct, and the FIA is committed to restoring the confidence of our customers. To that end we have issued our own recommendations for reform and we are working very closely with the CFTC and other market participants to strengthen customer protections. That process is not limited to the U.S., by the way. We also need to consider the cross-border implications, and I look forward to talking about that issue with organizations such as the SFOA, the FOA in London, and our members in Europe, Asia and elsewhere.

There is nothing more stimulating for law makers and regulators than a crisis (subprime, Lehman), a shock (flash crash) or a scandal (Enron, Worldcom). Can overregulation or wrong regulation be avoided this time?

Lukken: That is exactly the challenge we face. I think the answer is that policymakers should aim at what I would call «smart regulation». By that I mean the drafting of new laws and new regulations should take into account a careful analy-

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sis of costs and benefits. Of course it is important to legislate and regulate in a way that the crisis will not repeat itself. But as we do that we need to avoid creating an impossible burden on the firms and exchanges that must comply with these regulations. Equally important, we can't let our determination to fix the problems of the past blind us to the risks of the future. Regulators need to keep their eyes focused on the road ahead so that they can identify areas where the next crisis might emerge.

Walt, as the former CEO of a clearing house, what is your view on the question of mandatory clearing for OTC derivatives?

Lukken: In my opinion it is important that all standardised products go through a clearing house. By stressing the word «standardised» I want to make it clear that there is no argument to enforce mandatory clearing through a clearing house for any and every derivative product. If we push too many products into clearinghouses, or if we set a timetable for mandatory clearing that is too aggressive, we put the clearinghouses at risk of failure, and that is certainly not the outcome that anyone wants.

Derivatives trading is a global business dominated by global players, yet legislation and regulation is still national or at best regional. How do you act in view of this dichotomy?

Lukken: The Futures Industry Association makes every effort to pay tribute to this global character of the industry. Apart from our efforts on our home territory, the United States, we



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work very closely with our fellow bodies in Europe, i.e. FOA. We recently set up a Singapore office for FIA Asia and we are aiming to offer our expertise and our services to market participants in that region. It's obvious that there is tremendous potential growth in that region, and I expect to see much closer ties in the years to come.

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