RECOMMENDATIONS REPORT

BERKELEY RESEARCH GROUP, LLC

ANALYSIS OF THE NATIONAL FUTURES ASSOCIATION'S AUDITS OF PEREGRINE FINANCIAL GROUP, INC.

Introduction and Background

On August 2, 2012, the Special Committee for the Protection of Customer Funds ("Special Committee"), a committee comprised solely of Public Directors of the National Futures Association ("NFA")[1] retained professionals at Berkeley Research Group, LLC ("BRG Investigative Team") to conduct an independent review of NFA audit practices and procedures, and the execution of those procedures in the specific instance of Peregrine Financial Group, Inc. ("PFG"), to assure that adequate procedures are in place and that they are being followed properly.

The BRG Investigative Team was specifically tasked with:

- Conducting a review of the NFA audit regulatory framework over the period during which NFA conducted audits of PFG;
- Evaluating the execution of NFA audits of PFG; and
- Determining whether the applicable policies and procedures that govern the conduct of NFA audits could be improved.

On January 29, 2013, the BRG Investigative Team provided the Special Committee a comprehensive report of investigation ("Report of Investigation") describing all of the audits conducted by NFA of PFG from 1995 through 2012. The Report of Investigation found that, overall, the NFA audits were conducted in a competent and proper fashion and the auditors dutifully implemented the appropriate modules that were required in the annual audits. However, the BRG Investigative Team also found that certain areas, such as internal controls, Russell Wasendorf Sr.'s ("Wasendorf") capital contributions and PFG's reverse repurchase agreements ("repos") and sweep accounts, were not always examined closely in the audits. Additionally, the BRG Investigative Team found that Business Conduct Committee ("BCC") complaints and warnings against PFG prior to 2012 did not cause NFA to extend their audit procedures

[1] On March 28, 2012, following the collapse of MF Global, Daniel Roth, the President and Chief Executive Officer of NFA, testified before Congress that NFA had appointed a Special Committee for the Protection of Customer Funds comprised of the public directors on NFA's board. Testimony of Daniel J. Roth, President and Chief Executive Officer, National Futures Association, before the Oversight and Investigations Subcommittee of the Committee on Financial Services of the U.S. House of Representatives, March 28, 2012 at 1-2.

in connection with their audits of PFG.[2] The BRG Investigative Team also found that, in 2011, NFA received a confirmation statement from U.S. Bank showing an amount in PFG's customer segregated account that was substantially different than the amount shown in the U.S. Bank statement provided by PFG. There was little discussion among the audit team about this discrepancy, and no follow-up with U.S. Bank after a "corrected" confirmation was provided the next business day, which was discovered in 2012 to have been forged by PFG's Chief Executive Officer ("CEO"), Wasendorf.

This Recommendations Report summarizes the findings of the BRG Investigative Team and provides specific, concrete recommendations designed to improve the operations of the NFA audits based upon the findings in the Report of Investigation.

Audit Standards

NFA's audits differ from the required annual certified audit provided by an independent accounting firm in that NFA's audits are designed not only to test that the firm's financial statements are prepared in accordance with Generally Accepted Accounting Principles, but also to test the firm's compliance with pertinent NFA regulatory requirements.

Standards for NFA audits are established by the Joint Audit Committee ("JAC"). JAC is a representative committee of the Audit and Financial Surveillance departments of U.S. futures exchanges and regulatory organizations, including representatives of NFA and other Self-Regulatory Organizations ("SROs") as well as representatives of the U.S. Commodity Futures Trading Commission ("CFTC").[3] Through JAC, Futures Commission Merchants ("FCMs") are assigned a lead commodity SRO, such as NFA, that is responsible for performing risk-based examinations designed to meet the goals of customer protection and financial integrity.[4] Such examinations are conducted in accordance with the JAC Audit Program.[5] To the extent the JAC Audit Program is silent on an issue, the BRG Investigative Team looked to auditing standards developed by other standard setters, such as the American Institute of Certified Public Accountants ("AICPA") and the Public Company Accounting Oversight Board ("PCAOB"), that may be relevant.[6]

[2] The "complaints and warnings" referred to here are described in detail in the Report of Investigation and include, PFG's failure to calculate correctly segregated funds computations, PFG's issuance of misleading promotional material, PFG's failure to respond to information requests, and PFG's failure to supervise. Further, as noted in the Report of Investigation, the BRG Investigative Team specifically investigated whether NFA had received any specific tip or complaint indicating that Wasendorf was conducting a fraud and found none.

[3] 2NFA00682916 (Joint Audit Committee Audit Concepts, March 2007). Members of JAC are listed in the Report of Investigation and also at http://www.nfa.futures.org/NFA-compliance/joint-audit-committee.HTML

[4] According to NFA management, NFA is currently the auditor for 25 FCMs that hold customer funds.

[5] The BRG Investigative Team reviewed the 2002-2010 JAC Audit Programs. Examples: NFA03353289-NFA03353321 (JAC Program 2010 COMPLIANCE); NFA03353322-NFA03353368 (JAC Program 2010 FINANCIAL); NFA03353369-NFA03353391 (JAC Program 2010 GENERAL).

[6] The Sarbanes-Oxley Act of 2002, which created the PCAOB, required that auditors of U.S. public companies be subject to external and independent oversight for the first time in history. Previously, the auditing profession was self-regulated. Where appropriate, we cite standards from the PCAOB because the CFTC, in November 2012, proposed to require Certified Public Accountants ("CPAs") that audit FCMs to register with and be subjected to review by the PCAOB.

Findings and Recommendations

Finding I: Training and Proficiency of NFA Auditors Can be Enhanced.

A. Investigative Findings Related to Training and Proficiency

As described in the Report of Investigation, and as discussed in the findings and recommendations set forth below, the BRG Investigative Team found that some NFA auditors did not always exhibit sufficient professional skepticism in assessing and evaluating fraud risks, and did not always scrutinize thoroughly certain areas, such as internal controls, Wasendorf's capital contributions and PFG's repos and sweep accounts in audits of PFG. We found that in some cases, as detailed below and in the Report of Investigation, NFA auditors relied too much on representations made by PFG management and could have followed up and examined more closely issues that arose during the course of the PFG audits.

The BRG Investigative Team also found that many NFA auditors had little to no experience in the futures industry when they first joined NFA and that, after an initial several-week training course, many of these auditors immediately began actively working on audits of non-FCM firms and thereafter, FCM firms. We found that many NFA auditors were promoted to supervisory positions after a few years, at which point they were responsible for managing the audits and reviewing the work of the staff auditors. Several NFA auditors who were interviewed during the investigation expressed concerns about the experience level of, and support for, junior auditors at NFA. Additional auditors indicated that the lack of experience contributed to a "check-the-box" mentality when auditing FCMs, particularly when utilizing the modules and, as a result, NFA auditors lost sight of the "big picture." We found that, while more experienced NFA auditors were formally in charge of the field work, on several occasions, the experienced manager did not spend significant time in the field assisting the more junior auditors.

Still, the BRG Investigative Team also found that NFA auditors had an intensive training regimen, including several weeks at the outset of their employment with NFA and a second round of training approximately six months later. We believe that this training provided a proper foundation for the auditors. We also found that additional training was generally made available to NFA auditors over their tenure at NFA in different specialties. In addition, most auditors who were interviewed acknowledged that, consistent with industry practice, much of the knowledge required to be a successful auditor would come from on-the-job training.

The BRG Investigative Team found that there could have been better emphasis on "lessons learned" presentations after major industry events. For example, several auditors did not recall attending any training sessions to discuss lessons learned after the Madoff Ponzi scheme or the collapse of MF Global[7] related to the diversion of customer segregated funds were revealed.

To summarize, the BRG Investigative Team found that NFA auditors did not always exhibit sufficient professional skepticism, and found anecdotal evidence of inexperienced NFA auditors lacking support,

[7] We note that the MF Global scandal was first brought to light only 8 months before the PFG fraud was uncovered.

supervision, and "lessons learned" training. However, we did not find sufficient evidence to conclude that NFA audits of PFG were significantly placed at risk as a result.

B. Standards for Audit Training and Proficiency

AICPA standards prescribe the appropriate approach to be utilized in conducting audit work. For instance:[8]

> Due professional care requires the auditor to exercise professional skepticism. . . . Because of the characteristics of fraud, the auditor's exercise of professional skepticism is important when considering the fraud risks. Professional skepticism is an attitude that includes a questioning mind and a critical assessment of audit evidence. The auditor should conduct the engagement with a mindset that recognizes the possibility that a material misstatement due to fraud could be present, regardless of any past experience with the entity and regardless of the auditor's belief about management's honesty and integrity. Furthermore, professional skepticism requires an ongoing questioning of whether the information and evidence obtained suggests that a material misstatement due to fraud has occurred. In exercising professional skepticism in gathering and evaluating evidence, the auditor should not be satisfied with less-than persuasive evidence because of a belief that management is honest.

Ten Generally Accepted Auditing Standards ("GAAS") have been approved and adopted by the AICPA, and provide a measure of audit quality and the objectives to be achieved in an independent audit. The ten standards are comprised of three general standards, three standards of field work, and four standards of reporting. The general standards and the standards of field work are relevant to assessing the effectiveness of NFA audits, but this report will only address a subset of them. The GAAS standards are not expressly applicable in the context of regulatory audits, but the BRG Investigative Team believes that there are sufficient parallels to be drawn from them to enhance NFA's audit function.[9]

The first general standard is relevant to the training and proficiency of the auditor: "The audit is to be performed by a person or persons having adequate technical training and proficiency as an auditor."[10] Guidance for implementing the first general standard prescribes that proficiency be attained through adequate and relevant formal education, training, and subsequent professional experience. Training should include ". . . a continual awareness of developments taking place in business and in his profession."[11] Further, the guidance notes that a junior auditor must be properly supervised by an

[8] AU 316.13.
[9] GAAS standards were not explicitly stated in the JAC documents reviewed by the BRG Investigative Team. However, we noted similar objectives to be achieved in a GAAS audit and a JAC audit (i.e., use of an auditor's understanding of a firm's internal controls, process of gaining audit evidence through inspection, observation, inquiries and confirmations.)
[10] AU 210.01.
[11] AU 210.04.

experienced manager while still in the process of gaining professional knowledge through on-the-job experience.[12]

The third[13] general standard is also relevant to the training and proficiency of an auditor: "Due professional care is to be exercised in the planning and performance of the audit and the preparation of the report."[14] Guidance for implementing the third general standard suggests that one must have the appropriate level of relevant experience and formal training in order to exercise due professional care. Without formal training and adequate experience, an auditor does not have a basis on which to ensure that they have completed a task in accordance with due care. The guidance states that, "[a]n auditor should possess the 'degree of skill commonly possessed' by other auditors…"[15] and should be assigned to tasks that are commensurate with their level of "knowledge, skill and ability."[16]

Additional guidance about the training and proficiency of auditors can be found in quality control ("QC") standards established by the PCAOB, which are applicable to the systems of quality control used by CPA firms for their auditing practices. QC Section 40, *The Personnel Management Element of a Firm's System of Quality Control-Competencies Required by a Practitioner-in-Charge of an Attest Engagement*, requires that firms have policies and procedures in place to provide the CPA firm with reasonable assurance that: [17]

a. Those hired possess the appropriate characteristics to enable them to perform competently. Examples of such characteristics may include meeting minimum academic requirements established by the firm, maturity, integrity, and leadership traits.

b. Work is assigned to personnel having the degree of technical training and proficiency required in the circumstances.

c. Personnel participate in general and industry-specific continuing professional education and other professional development activities that enable them to fulfill responsibilities assigned, and satisfy applicable continuing professional education requirements of the AICPA, and regulatory agencies.

d. Personnel selected for advancement have the qualifications necessary for fulfillment of the responsibilities they will be called on to assume.

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[12] AU 210.03.
[13] The second general standard relates to independence of the auditor in mental attitude (AU 150).
[14] AU 230.01.
[15] AU 230.05.
[16] AU 230.06.
[17] QC 40.02.

These steps emphasize the importance of relevant experience and training, given the significant responsibilities required of personnel engaged in audits.[18]

In terms of recruiting qualified personnel, the BRG Investigative Team noted that, as a result of the Madoff Ponzi scheme, the Securities and Exchange Commission ("SEC") has made significant progress hiring staff with diverse and specialized skills to improve its ability to conduct its examinations.[19] The BRG Investigative Team also recognizes the importance of continuous training that keeps auditors up to date on the latest business and industry developments, which is also consistent with practices at the SEC.[20] In addition, the SEC has implemented an accounting fellowship program that, if adopted by the NFA, may be utilized to provide industry accounting experts to the NFA audit program on a rotating basis.[21]

C. Recommendations for Improvements in NFA Training Program and Auditor Proficiency

1. NFA should update and revise its audit training, guidance, planning and other audit modules to ensure its auditors conduct audits and examinations with appropriate professional skepticism that includes a questioning mind and a critical assessment of audit evidence, in particular with respect to reliance on representations of management regarding key risk areas.

2. NFA should establish protocols to ensure that appropriate levels of supervisory audit personnel spend sufficient time on-site to provide any needed support and supervision to audit personnel during audits of FCMs.

3. NFA should evaluate its hiring practices to ensure it employs auditors with diverse skill sets, which will expand NFA's knowledge base and improve NFA's ability to assess risk, conduct audits, detect and investigate wrongdoing and focus priorities.

4. NFA should assess the feasibility of establishing a rotation program with prominent accounting firms to allow for auditors from those firms to serve for prescribed periods of time at NFA in order for NFA auditors to gain valuable audit industry experience.

5. NFA should integrate event-driven programs into its ongoing training regime to ensure that NFA auditors are informed of lessons learned from events that occur in the financial industry, as well as specialized products and new industry developments that affect NFA audits.

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[18] In our review of JAC standards, we did not locate any specific language with regard to audit training. Although JAC has not formally adopted PCAOB or AICPA standards, as noted above, to the extent that the JAC Audit Program is silent on an issue, the BRG Investigative Team looked to auditing standards developed by other standard setters.
[19] http://www.sec.gov/spotlight/secpostmadoffreforms.htm#conduct.
[20] *Id.*
[21] http://www.sec.gov/news/extra/pafprogram.htm.

D. NFA Initiatives Related to Training and Proficiency

NFA management indicated that it would review both its initial and ongoing training materials to ensure that these materials emphasize the importance of professional skepticism in the audit and examination process. Additionally, Compliance Department senior management will continue to emphasize the need for professional skepticism in its meetings with NFA compliance staff. NFA also intends to continue to rotate its compliance staff through the program for obtaining the Certified Fraud Examiner designation from the Association of Certified Fraud Examiners,[22] which highlights the importance of professional skepticism. Finally, NFA will continue to consider the exhibition of this attribute as an important factor in determining promotions and will ensure that staff understands the importance of this factor in promotions.

NFA management has also noted success with recent efforts to employ experienced field supervisors and managers. Recent hires include former traders, former Financial Industry Regulatory Authority ("FINRA") and SEC examiners, and individuals who have earned the designation of Certified Fraud Examiner. NFA has also indicated that efforts are underway to ensure that managers spend more time in the field to provide necessary support for field supervisors and staff auditors.

NFA management also commented that NFA has held event-driven training sessions, but attendance has been voluntary, not mandatory. NFA provided the BRG Investigative Team with "lessons learned" presentations arising out of recent industry events pertaining to Refco, the Kerviel "rogue trader" matter at Societe General, and the "London Whale" matter at JP Morgan. NFA management also noted that it communicates other matters of interest related to the financial industry as they arise through its First Call meetings (weekly meetings of the NFA Compliance Department), weekly manager meetings, and in weekly email updates. Another forum for addressing "lessons learned" are the Technical Roundtable meetings, at which senior staff answer technical questions posed by staff or that emerge from manager reviews of staff work. One example of a Technical Roundtable that addressed "lessons learned" from an industry issue was a November 23, 2009, session led by an auditor addressing the 2009 FINRA report analyzing FINRA's handling of the Stanford and Madoff Ponzi scheme cases.

NFA also trains staff by inviting speakers to present an outside perspective on important issues. For example:

- In April 2010, the Chicago Mercantile Exchange ("CME") gave a presentation to NFA staff on cleared Over-the-Counter ("OTC") derivatives.
- In November 2010, long-time industry members of the Institute for Regulatory Training gave a two-day trading analysis program.
- In August 2011, FINRA discussed broker-dealer customer protection and financial statements.
- In December 2011, Financial Crimes Enforcement Network provided training on anti-money laundering and suspicious activity reports.
- In January 2012, the CME Group presented on its cleared agricultural swaps products.

[22] http://www.acfe.com.

- Also in January 2012, the head of compliance at Nadex, discussed its binary options and how they trade.
- Most recently, in November 2012, a Managing Director at Knight Trading gave a presentation entitled "Risk Management Primer."

Finding II: The NFA's Risk Assessment Guide and Planning Module Can be More Consistently Utilized and Updated.

A. Investigative Findings Related to Risk Assessment Guide and Planning Module

NFA has been using a Risk Assessment Guide to assist with the planning and scoping of audits of FCMs since 2000. The Risk Assessment Guide can be used as a supplement to the NFA Planning Module, which is typically prepared prior to an audit, and includes steps to obtain information regarding the firm's business operations.

In the Report of Investigation, the BRG Investigative Team found a lack of consistency and documentation in the use of the Risk Assessment Guide[23] in connection with the Planning Module. The BRG Investigative Team also found that the Risk Assessment Guides and Planning Modules used by NFA did not appear to reflect significant developments in connection with the audits of their member firms. For instance, the Risk Assessment Guides and Planning Modules did not incorporate specific concerns or "lessons learned" from the Madoff Ponzi scheme or the collapse of MF Global[24] that could be used to identify similar risks or issues at firms that were being audited.

To summarize, the BRG Investigative Team found a lack of consistency and documentation in the use of the Risk Assessment Guide in connection with the Planning Module. Although completion of a well-designed risk assessment guide or planning module may not, by itself, uncover fraud, thorough consideration of risk should result in an audit designed with audit procedures that adequately address identified risks.

B. Standards for Risk Assessment

JAC's general and risk-based scope audit programs include, in part, steps for establishing the scope of the exam, completing the preliminary risk analysis review, and documenting the firm profile. In addition, the JAC Audit Program provides a general questionnaire which, once completed by the auditor, documents the firm's financial, operational and risk management procedures and practices. Topics covered include, among other things, the controls, policies, personnel, and systems of the firm's financial records, changes in relationships with third parties, account monitoring procedures (margining

[23] NFA management notes that the use of the risk assessment guide was voluntary.
[24] We note that the MF Global scandal was first brought to light only 8 months before the PFG fraud was uncovered.

and risk management analysis), customer proprietary, noncustomer, and affiliate trading and segregation of cash and settlement responsibilities.[25]

The AICPA has also issued guidance related to risk assessment. The AICPA periodically issues Statements on Auditing Standards ("SAS"). 8 SASs related to risk assessment were issued in March 2006 and became effective for audits of financial statements for periods beginning on or after December 15, 2006. Again, while these standards are not expressly applicable in the context of regulatory audits, the BRG Investigative Team believes that there are sufficient parallels that will enable NFA to enhance its audit processes and procedures.

The AICPA described the objectives and development of the new standards in an Audit Risk Alert:[26]

> The Auditing Standards Board (ASB) believes that the SASs represent a significant strengthening of auditing standards that will improve the quality and effectiveness of audits. The primary objective of the SASs is to enhance your application of the audit risk model in practice by requiring, among other things:
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> - A more in-depth understanding of your audit client and its environment, including its internal control. This knowledge will be used to identify the risk of material misstatement in the financial statements (whether caused by error or fraud) and what the client is doing to mitigate them.
> - A more rigorous assessment of the risk of material misstatement of the financial statements based on that understanding.
> - Improved linkage between the assessed risks and the nature, timing, and extent of audit procedures performed in response to those risks.
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> The development of these SASs was undertaken in response to recommendations to the ASB made by the former Public Oversight Board's Panel on Audit Effectiveness. In addition, the major corporate failures of the past several years have undermined the public's confidence in the effectiveness of audits and led to an intense scrutiny of the work of auditors, and the development of the SASs also have been influenced by these events.

SAS No. 109, entitled *Understanding the Entity and its Environment and Assessing the Risks of Material Misstatement* ("SAS No. 109") and issued in March 2006, is a risk assessment audit standard relevant to many of the BRG Investigative Team's findings and recommendations. It describes procedures that the

[25] 2NFA00682916 (JAC Audit Concepts, March 2007) and NFA03353369-NFA03353391 (General Audit Program, March 2010). This general summary also applies to the General Audit Program for 2002-2009.
[26] AICPA Audit Risk Alert, *Understanding the New Auditing Standards Related to Risk Assessment – 2005/06*, ¶.03-.04.

auditor should perform in order to obtain a full understanding of the entity and its environment, including its internal controls.[27]

SAS No. 109 describes the importance of risk assessment as follows: [28]

> Obtaining an understanding of the entity and its environment is an essential aspect of performing an audit in accordance with generally accepted auditing standards. In particular, that understanding establishes a frame of reference within which the auditor plans the audit and exercises professional judgment about assessing risks of material misstatement of the financial statements and responding to those risks throughout the audit . . . .

Further, SAS No. 109 provides that "[t]he auditor's understanding of the entity and its environment consists of an understanding of the following aspects:

a. Industry, regulatory, and other external factors
b. Nature of the entity
c. Objectives and strategies and the related business risks that may result in a material misstatement of the financial statements
d. Measurement and review of the entity's financial performance
e. Internal control, which includes the selection and application of accounting policies." [29]

C. Recommendations Related to Risk Assessment and Planning Module

6. NFA should update its policies and procedures to ensure more consistent, effective, and documented use of its Planning Module in connection with the financial review audits of FCMs.

7. NFA should develop mechanisms to ensure that the Planning Module is modified and updated on a regular basis to incorporate industry, regulatory, and other external factors, including *ad hoc* updates to incorporate lessons learned from significant events that occur in the financial industry.

D. NFA Initiatives Related to Risk Assessment and Planning Module

NFA management stated that they believe the Risk Assessment Guide has been in use since 2000. They acknowledged there were ways in which they could improve the process so that all applicable information could be incorporated into the risk assessment steps contained in the Planning Module.

NFA management also noted that it recently modified the charter and updated the membership of the Compliance and Risk Committee (the "Committee"). According to its charter, the Committee's principal

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[27] AICPA Audit Risk Alert, *Understanding the New Auditing Standards Related to Risk Assessment – 2005/06*, ¶.14.
[28] AU 314.03.
[29] AU 314.21.

responsibility is to advise staff, the Executive Committee and Board of Directors regarding compliance and risk related matters. Specifically, in performing its advisory function, the Committee may:

- Discuss regulatory and market issues that may pose compliance and financial risks to NFA's Member firms;
- Discuss regulatory and market issues arising from trends and issues identified in NFA's examinations;
- Discuss selected investigations;
- Discuss trends and issues associated with BCC cases that have been initiated and/or closed;
- Discuss CFTC rule enforcement reviews relating to NFA's compliance activities;
- Discuss NFA's sanctioning guidelines;
- Discuss NFA's proposed rulemakings and petitions for rulemaking to the CFTC regarding compliance-related issues; and
- Perform an oversight role relating to the systems developed and utilized by NFA's compliance staff.

Finding III: The Scrutiny of Internal Controls During NFA Audits Can be Improved.

A. Investigative Findings Related to Review of Internal Controls

The BRG Investigative Team found that PFG exhibited some fraud risk factors, in particular, the presence of a domineering CEO. Wasendorf declared in his confessional statement that he used “blunt authority” to manage and hide his fraud. Wasendorf’s use of intimidating authority was corroborated by former PFG Chief Financial Officer (“CFO”), Tom Pearson (“Pearson”). In Wasendorf’s December 2012 interview with the BRG Investigative Team, he explained that he demanded that U.S. Bank statements be sent directly and exclusively to him and insisted that he be the only signatory for the U.S. Bank account that held customer funds.

However, NFA auditors were unaware of the lack of controls over that account when planning or conducting the audits. BRG’s investigation found that none of the 23 NFA auditors interviewed were aware that Wasendorf was the only individual at PFG who received the original (i.e. actual) U.S. Bank account statements directly from the bank. Several auditors stated that this type of information normally would not be requested as part of an NFA audit; however, we found that internal control review is incorporated into NFA training.

Our investigation showed that internal controls were not a major area of focus of NFA audits.

B. Standards of Review of Internal Controls

The AICPA's second standard of fieldwork states that: "A sufficient understanding of internal control is to be obtained to plan the audit and to determine the nature, timing, and extent of tests to be performed."[30] In addition, the AICPA has issued Statements on Auditing Standards that provide guidance about implementing the second standard of field work.[31]

For instance, SAS No. 78, effective in 1997, advises that "[internal control] knowledge is ordinarily obtained through previous experience with the entity and procedures such as inquiries of appropriate management, supervisory, and staff personnel; inspection of entity documents and records; and observations of entity activities and operations."[32]

Similarly, SAS No. 109, effective in 2006, provides the following:[33]

> The auditor should perform the following risk assessment procedures to obtain an understanding of the entity and its environment, including its internal control:
>
> a. Inquiries of management and others within the entity,
> b. Analytical procedures,
> c. Observation and inspection.

For example, to obtain knowledge about an FCM's internal controls over the reporting of cash balances, an auditor can make inquiries of the bookkeeper responsible for performing bank reconciliations. The auditor can also examine bank records, including lists of authorized signatories, withdrawal requests and bank statements.

The internal control standard also is generally reflected in the JAC Audit Program:

> Certain programs and/or audit steps may or may not be selected for testing based on an assessment of the firm's internal controls, customer complaints, results of past audits, restrictions imposed on the firm, a profile of accounts carried, its order and solicitation process, and the general nature of its business operations.[34]

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[30] AU 150.02; http://pcaobus.org/Standards/Auditing/Pages/AU150.aspx. In 2006, SAS No. 105 expanded the scope of the understanding that the auditor must obtain in the second standard of field work from "internal control" to "the entity and its environment, including its internal control."

[31] SAS No. 78, *Consideration of Internal Control in a Financial Statement Audit: An Amendment to Statement on Auditing Standard No. 55* and SAS No. 109, *Understanding the Entity and its Environment and Assessing the Risks of Material Misstatement*. In addition, SAS No. 78 and SAS No. 109 refers to *Internal Control—Integrated Framework*, published by the Committee of Sponsoring Organizations of the Treadway Commission.

[32] AU 319.58.

[33] AU 314.06.

[34] NFA03353322 (JAC Financial, Revised March, 2010).

The BRG Investigative Team noted that, although the JAC Audit Program contains general references to internal controls, there were no instructions or specific steps provided that describe how to perform an adequate assessment of a firm's internal controls.[35]

The BRG Investigative Team reviewed JAC meeting minutes that discussed JAC's annual reviews of its audit programs. However, it was not clear if JAC reviewed and considered new pronouncements in auditing literature or tested the effectiveness of its audit modules.

C. Recommendations Related to Review of Internal Controls

8. NFA should update its modules for the audits of FCMs to incorporate specific and concrete steps to identify internal control risks in firms, including inquiries of appropriately qualified management, supervisory, and staff personnel; segregation of duties; inspection of entity documents and records; and observations of entity activities and operations.

9. NFA should work with JAC to monitor developments in auditing literature, including new pronouncements from the PCAOB, AICPA and COSO,[36] and integrate those new pronouncements into NFA audit modules and other guidance, as appropriate.

10. NFA should evaluate how best to improve its audit process in order to ensure it includes review of regulatory problems that have surfaced but were not detected previously, and modify the audit modules as appropriate, to ensure that improvements are made to reflect the problems identified.

D. NFA Initiatives Related to Review of Internal Controls

NFA management noted that NFA tests internal controls indirectly through its examination of compliance with NFA requirements. However, NFA management also acknowledged that there should be more emphasis placed on internal controls in NFA audits of FCMs. NFA management further noted that FCMs also should be required to comply with specific standards for internal controls, and that NFA anticipates issuing guidance to that effect in the near future.

NFA has drafted an Interpretive Notice ("Draft IN") regarding FCM internal control requirements. The Draft IN would require firms to maintain internal controls in prescribed areas. In each of these areas, the Draft IN highlights the key objective for the area and identifies minimum requirements. The Draft IN also requires each FCM to have written policies and procedures that fully describe how the internal controls are implemented. The FCM's policies and procedures are required to be approved by the firm's CEO, CFO, or a listed principal with knowledge of the firm's financial requirements and position. Finally,

[35] NFA03353371; NFA03353291; NFA03353322.

[36] The Committee of Sponsoring Organizations of the Treadway Commission ("COSO") is dedicated to providing thought leadership through the development of frameworks and guidance on enterprise risk management, internal control and fraud deterrence.

the Draft IN requires FCMs to conduct regular reviews of their internal controls to ensure that they are being implemented properly and that the internal controls are effective.[37]

Finding IV: The Level of Scrutiny of Qualifications and Promotions of Senior Officials of an FCM Can be Improved.

A. Investigative Findings Related to Qualifications of Senior Officials

The BRG Investigative Team found that PFG's CFO from 2006 to 2012, Brenda Cuypers ("Cuypers"), was promoted to the position even though she initially was hired by PFG as an assistant bookkeeper and then worked as PFG's controller. We found that Cuypers' formal education consisted of an associate's degree from Hawkeye Community College in Iowa, and that she never attended or participated in any accounting or auditing classes or continuing education to supplement her associate's degree. The BRG Investigative Team found that when she obtained the CFO position after Pearson left, there were no other candidates considered for the position of CFO at PFG.

The BRG Investigative Team further found that NFA auditors did not review the qualifications of PFG's new CFO in 2006, nor did they consider the qualifications of the CFO when planning the scope of PFG's audits. The investigation revealed that NFA auditors generally did not scrutinize the qualifications of senior PFG officials.

B. Standards of Assessing Qualifications of Senior Officials

As previously discussed, SAS No. 109 instructs the auditor to obtain an understanding of the entity, including its internal controls, so that he can complete a risk assessment for use when designing and performing audit tests.[38]

SAS No. 109 prescribes that "[t]he auditor should obtain an understanding of the five components of internal control sufficient to assess the risk of material misstatement of the financial statements whether due to error or fraud, and to design the nature, timing, and extent of further audit procedures."[39] One of the five components of internal control is Control Environment: "The control environment sets the tone of an organization, influencing the control consciousness of its people. It is the foundation for effective internal control, providing discipline and structure."[40]

SAS No. 109 advises the auditor to consider the following elements of the control environment:[41]

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[37] NFA staff recently requested input from its FCM Advisory Committee and several CPA firms, including those that FCMs engage for annual audit work, on the substance of the guidance. NFA staff intends to have a final document to present to its Board of Directors at its May 2013 meeting and, if approved, will make it effective shortly thereafter.

[38] AU 314.01.

[39] AU 314.40.

[40] AU 314.B2.

[41] The control environment encompasses many elements described at AU 314.B3. Elements relevant to this topic are included in this list.

- Policies relating to appropriate business practices, knowledge and experience of key personnel, and resources provided for carrying out duties. [Emphasis added.]
- Human resource policies and practices relating to recruitment, orientation, training, evaluating, counseling, promoting, compensating, and remedial actions. For example, standards for recruiting the most qualified individuals – with emphasis on educational background, prior work experience, past accomplishments, and evidence of integrity and ethical behavior – demonstrate an entity's commitment to competent and trustworthy people.

Furthermore, the JAC Audit Program directs auditors, during the planning phase, to identify specific firm personnel responsible for (a) financial statement preparation, (b) daily position and money balancing, and (c) general compliance/sales practice areas. Auditors are instructed to detail the backgrounds of relevant individuals new to their positions.[42]

Upon implementing the guidance from the JAC Audit Program or from SAS No. 109, an auditor may identify an inexperienced CFO as a control weakness. Further, the auditor may address the control weakness by performing more substantive audit procedures on certain high-risk financial statement accounts.

C. Recommendation Related to Qualifications of Senior Officials

11. NFA should update its modules for the audits of FCMs to incorporate specific and concrete steps to obtain an understanding of risk factors in audits relating to the control environment at an FCM, including, among other things, a better understanding of the effects of the "tone at the top" of an organization (*see* PCAOB AU § 314.40-41), domineering management behavior, policies relating to appropriate business practices, knowledge and experience of key personnel, and resources provided for carrying out duties.

D. NFA Initiatives Related to Qualifications of Senior Officials

NFA management stated that they have made inquiries into the qualifications of senior-level officials at FCMs when its testing indicated a problem with their work or in connection with their responsibilities, but not as a matter of routine. As evidence of such inquiries, the BRG Investigative Team noted that NFA questioned the qualifications of PFG's new anti-money laundering officer in a letter dated March 15, 2012. In addition, the BRG Investigative Team noted that the 2010 FCM and Introducing Broker Applicant Interview module was designed to direct NFA to scrutinize the qualifications of an applicant's executives.

[42] NFA03353369-NFA03353391 (JAC Program 2010 GENERAL) at NFA03353374.

Finding V: The Level of Scrutiny of FCM's Outside Auditing Firms, and Their Work Product, Could be Enhanced.

A. Investigative Findings Related to Outside Auditing Firms

The BRG Investigative Team found that the NFA auditors who participated in audits of PFG generally were aware that PFG used an outside accounting firm, but were not aware that the accounting firm, Veraja-Snelling & Company, was, particularly in the later audits, a small firm located in the suburbs of Chicago. An NFA field supervisor stated that NFA traditionally did not look at the experience, background, or expertise of an FCM's outside auditing firm.

In addition, a review of the audit files for the PFG audits from 1995 through 2012 revealed that NFA auditors did not examine the outside auditor's workpapers or spend any significant time meeting with PFG's outside auditor.

B. Standards Related to Outside Auditing Firms

As previously discussed, SAS No. 109 instructs the auditor to obtain an understanding of the entity and its environment. Appendix A to SAS No. 109 provides guidance on matters the auditor may consider when obtaining this understanding. For example, the auditor may consider important suppliers of services, as well as financial reporting issues and new accounting requirements.[43]

The AICPA has issued guidance for independent auditors about providing access to workpapers. The guidance acknowledges that access to workpapers may be appropriate where required by "law, regulation or audit contract." For example, a regulator may request access to the workpapers to fulfill a quality review requirement or to assist in establishing the scope of a regulatory examination.[44]

Therefore, an audit contract may be used to require an FCM's auditor to provide workpaper access to NFA, for the purpose of planning and executing NFA audits.

C. Recommendations Related to Outside Auditing Firms

12. NFA should update its modules for the audits of FCMs to incorporate specific and concrete steps to develop an understanding of the qualifications of the CPA firm performing the FCMs' annual audit.

13. NFA should consider requiring FCMs that hold customer funds to consent to permitting the firm's CPA to meet and confer with NFA auditors, at the request of NFA, regarding the CPA's most recent audit and findings and, where appropriate and requested by NFA, provide NFA with any workpapers related to the audit. NFA also should consider updating its audit modules to require that it confer with the CPA of any FCM that holds

[43] AU 314.A3-A4.
[44] AU 9339A.01.

customer funds prior to NFA's annual examination of the firm on the scope and coverage of the CPA's audit and any material findings.

14. NFA should consider the information obtained in discussions with the FCM's CPA (as described in the preceding recommendation) in planning and setting scopes in its annual examination. NFA also should consider whether it would be necessary to review any of the CPA's workpapers in setting the scopes in its annual examination.

D. NFA Initiatives Related to Outside Auditing Firms

NFA management indicated that both NFA and the CFTC are contemplating whether they should enforce higher standards for CPAs who act as outside auditors for FCMs.

For instance, in November 2012, the CFTC proposed to amend its regulations "to impose an obligation on an FCM's governing body to ensure that a public accountant is qualified to perform an audit of the FCM by assessing the firm's experience in auditing FCMs, the firm's experience and knowledge of the Act and Commission regulations, and the depth and experience of the firm's auditing staff."[45]

Finding VI: The Level of Scrutiny of an FCM's Profitability and Capital Contributions Can be Improved.

A. Investigative Findings Related to Profitability and Capital Contributions

The BRG Investigative Team found that PFG incurred losses in 6 out of the 10 years for which financial statements were available for review.[46] During the 6 years that it lost money, PFG losses totaled $16,602,143. Profits totaled $4,101,086 in the 4 years PFG made a profit. In the aggregate, PFG lost $12,501,057 between 2000 and 2011, excluding 2002 and 2003, for which financial statements were not available.

Moreover, PFG's accumulated deficit suggests that in 2002 and 2003 PFG incurred further losses of approximately $2,166,000.[47] Similarly, based on the accumulated deficit, PFG incurred total pre-tax losses in excess of $6,822,000 in its first eight years of operation.[48] Therefore, PFG's accumulated deficit was approximately $21 million by December 31, 2011. NFA audit workpapers revealed that Wasendorf has always been the sole or majority shareholder of PFG[49] and purportedly contributed $69,125,000 in capital contributions to PFG between 2000 and 2011. These purported contributions were made to compensate for losses, to meet increased minimum net capital requirements and to create the appearance of a better capitalized firm. In our review of the NFA audit files, we found that NFA took note of the large, recurrent capital contributions in response to losses as early as 1999. However, the

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[45] http://www.cftc.gov/LawRegulation/FederalRegister/ProposedRules/2012-26435 at 33.
[46] PFG Forms 1-FR-FCM were not available for 2002 and 2003 as well as for years before 2000.
[47] PFG Forms 1-FR-FCM for: NFA00038553-NFA00038586 (2001) and NFA0004338553-NFA00043352 (2004).
[48] PFG Form 1-FR-FCM for: NFA00042217-NFA00042222 (2000).
[49] NFA audit workpapers from 2003-2005 indicate two other shareholders, but each shareholder is noted as holding less than 1% of PFG shares.

BRG Investigative Team found that, until 2012, NFA auditors did not scrutinize either the fact that PFG was losing significant money in many years or Wasendorf's frequent capital contributions.

We found that an auditor who worked on two PFG audits stated that he did not take note of PFG's losses or the capital contributions and that, in his experience, NFA would not have analyzed the possibility of money laundering by Wasendorf, since NFA's "anti-money laundering [module] [was] more about looking at customers laundering money through the firm rather than employees themselves laundering money through the firm."[50]

B. Standards Related to Profitability and Capital Contributions

Although the JAC Audit Program includes general guidance during the planning stage of an audit, we found no evidence of specific prescribed JAC audit steps to be performed on owner's equity or capital contributions.

Guidance in SAS No. 109 states that an auditor:[51]

> [S]hould obtain an understanding of the measurement and review of the entity's financial performance. Performance measures and their review indicate to the auditor aspects of the entity's performance that management and others consider to be important. Performance measures, whether external or internal, create pressures on the entity that, in turn, may motivate management to take action to improve the business performance or to misstate the financial statements. Obtaining an understanding of the entity's performance measures assists the auditor in considering whether such pressures result in management actions that may have increased the risks of material misstatement.

Anti-money laundering procedures may be relevant to identify potential fraudulent transfers of capital. The *International Money Laundering Abatement and Anti-Terrorist Financing Act* of 2001 ("Title III") was signed into law on October 26, 2001. Title III imposes anti-money laundering requirements on all "financial institutions," as defined under the Bank Secrecy Act, including FCMs.[52]

Section 352 of Title III and NFA Compliance Rule 2-9(c) requires all financial institutions to establish anti-money laundering programs which, at a minimum, must include internal policies, procedures and controls; a designated compliance officer to oversee day-to-day operations of the program; an ongoing training program for employees; and an independent audit program to test the program.[53]

[50] Tr. of Current Auditor no. 9 at 41:17-22. We note that while anti-money laundering reviews as designed, were not specifically relevant to Wasendorf's fraud, extending the anti-money laundering module beyond its customer focus would have subjected Wasendorf's capital contributions to further scrutiny.
[51] AU 314.34.
[52] https://www.nfa.futures.org/nfamanual/NFAManual.aspx?RuleID=9045&Section=9.
[53] *Id*. We note that the JAC Anti-Money Laundering module is consistent with NFA Compliance Rule 2-9.

C. Recommendations Related to Profitability and Capital Contributions

15. NFA should update its modules for the audits of FCMs to incorporate specific and concrete steps to develop an understanding of the measurement and review of an FCM's financial performance, including analysis of the financial standing of the FCM and any reasons that management may be motivated to take inappropriate action to improve business performance or to alter the FCM's financial statements.

16. NFA should update its modules for the audits of FCMs, including possibly its anti-money laundering policies, to incorporate specific and concrete steps to obtain an understanding of the sources of material capital contributions made by senior officials into the FCM over time.

D. NFA Initiatives Related to Profitability and Capital Contributions

NFA management stated that there have been instances where NFA was able to identify possible money laundering at other FCMs from analyzing the capital contributions into a firm with the use of the anti-money laundering module. Nevertheless, NFA management began profiling FCMs during 2012. Each FCM's profile includes month-to-month financial analysis and the profiles are now provided to managers for audit planning purposes.

Finding VII: There May be Areas Where NFA Can Enhance How it Interacts with FCM Officials During Audits.

A. Investigative Findings Related to Interaction with PFG Officials

The BRG Investigative Team found that NFA's audits of PFG over the years were made more difficult in some instances because of the perceived aggressive approach and demeanor of PFG's Director of Compliance, Susan O'Meara ("O'Meara"), who worked for the NFA prior to joining PFG. We found that O'Meara was known for "being stern and difficult to work with" and NFA auditors may have felt intimidated by her.

B. Standards Related to Interactions with FCM Officials

SAS No. 109 guides the auditor to make risk assessments based on an understanding of the entity, its environment, and its internal control. An auditor must also consider fraud risk when making risk assessments and then design and perform audit procedures whose nature, timing, and extent are responsive to overall risk assessments. [54]

[54] AU 314.01.

AICPA guidance describes "domineering management behavior" as a fraud risk: [55]

> The following are examples of risk factors relating to misstatements arising from fraudulent financial reporting . . . domineering management behavior in dealing with the auditor, especially involving attempts to influence the scope of the auditor's work.

Further, an external auditor must also be attentive to fraud indicators beyond the planning stage and throughout the entire audit:[56]

> The auditor's assessment of the risks of material misstatement due to fraud should be ongoing throughout the audit. Conditions may be identified during fieldwork that change or support a judgment regarding the assessment of the risks, such as . . . problematic or unusual relationships between the auditor and management, including . . . <u>management intimidation of audit team members</u>, particularly in connection with the auditor's critical assessment of audit evidence or in the resolution of potential disagreements with management. [Emphasis added.]

C. Recommendations Related to Interactions with FCM Officials

17. NFA should develop specific guidance and support for staff auditors or field supervisors who encounter during the course of an audit, representatives of FCMs or any NFA member firm, who act in an intimidating, intransigent or uncompromising manner.

D. NFA Initiatives Related to Interactions with FCM Officials

NFA management indicated that it would be appropriate for there to be more specific guidance for junior auditors on exactly how to deal with intransigent or unprofessional firm personnel.

Finding VIII: The Level of Coordination between a BCC Action and an Annual Audit Can be Improved.

A. Investigative Findings Related to BCC Action and Annual Audits

The BRG Investigative Team found that PFG had been subject to several disciplinary complaints and/or warnings brought by the BCC over the years. We further found that, with the exception of the 1996 BCC complaint, these BCC complaints and warnings against PFG prior to 2012 did not cause NFA to extend their audit procedures in connection with their audits of PFG.

The BRG Investigative Team did find that, at least for the 1996 BCC complaint, all subsequent audits included examinations of segregation, supervision and promotional material which were the subjects of the 1996 complaint.

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[55] AU 316.17 for audits of financial statement for periods ending on or after December 15, 1997. AU 316 was amended in 2002 and 2010, but the fraud risk factor relating to "domineering management behavior" remains to this date. For instance, *see* AU 316.85 for audits of fiscal years beginning on or after December 15, 2010.

[56] AU 316.68 for audits of fiscal years beginning on or after December 15, 2002 but before December 15, 2010 and Appendix C of Auditing Standard 14 for audits of fiscal years beginning on or after December 15, 2010.

B. Standards Related to BCC Action and Annual Audits

The JAC Audit Program directs an auditor, during the audit planning stage, to "[c]onsult other Compliance Departments, Clearing Houses (Trade Practice, Market Surveillance, and Risk Management), NFA and SROs where the firm has membership privileges. Identify and document any material problems they have had with the subject firm which would affect the scope of our review."[57] No further instruction is provided in the JAC Audit Program.

Further, SAS No. 109 requires a financial statement auditor to understand industry, regulatory, and other external factors of an entity.[58] SAS No. 109 is relevant in part because some regulatory issues, such as warnings and actions brought by the BCC, may involve financial statement items.

C. Recommendation Related to BCC Action and Annual Audits

18. NFA should reinforce its existing policies and procedures to ensure that the reports and critical details of a BCC action against an FCM, or its principals, be shared with NFA auditors conducting audits of the FCM, as well as regulatory actions of the SEC, CFTC, FINRA, and others. NFA also should reinforce its existing policies and procedures to ensure NFA auditors examine material civil actions against an FCM as part of their assessment and audit planning process.

D. NFA Initiatives Related to BCC Action and Annual Audits

NFA management stated there was and is an intention to ensure that NFA auditors are aware of the issues related to the BCC actions against firms like PFG, but felt it was possible that this intention was not entirely conveyed to the staff in every audit.

Finding IX: The Level of Scrutiny of an FCM's Repurchase Agreements and Sweep Accounts Can be Improved.

A. Investigative Findings Related to Repurchase Agreements and Sweep Accounts

The BRG Investigative Team found that, in order to invest segregated account cash, PFG entered into repos with U.S. Bank and its predecessor, Firstar. The master repurchase agreement between PFG and Firstar was dated December 12, 1994. We found that PFG's repos were subject to various test procedures during NFA's periodic exams. However, NFA auditors did not identify the U.S. Bank repo balance or structure as either high-risk or problematic despite:

- The magnitude of the balance;
- The lack of separation of duties and weak internal controls over cash and investments;

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[57] NFA03353369-NFA03353391 (JAC Program 2010 GENERAL). This was the same for the 2002-2009 JAC Programs except that "Clearing houses," "risk management," and "NFA and SRO's" as examples were added over time.
[58] AU 314.24-25.

- The fact that they repeatedly noted that the value of PFG's repo was omitted from the ending balance on the bank statement provided by PFG yet included in the balance on the confirmation supposedly provided by U.S. Bank, which was later determined to be forged;
- PFG's apparent lack of compliance with CFTC Rules 1.20 and 1.25 with respect to the maintenance of separate accounts designated as "customer segregated accounts;"
- The apparent lack of daily repo confirmations, despite regulatory requirements that such be provided;
- The apparent reliance upon representations of PFG management that, in retrospect, may not have been borne out by the facts; and
- The reliance on previous audits from 2003-2008, which did not test repos, despite the fact that they were the largest growing means of investing customer funds at PFG.

As described in the Report of Investigation, when deposit sweep funds are invested in U.S. government securities, appropriate agreements must be in place, required disclosures must be made, and daily confirmations must be provided to the customer. As described in the JAC Audit Program for repos, "a written confirmation to the FCM specifying the terms of the agreement and/or a safekeeping receipt must be issued upon entering into the transaction and upon subsequent resale or repurchase."[59]

The BRG Investigative Team found that the NFA auditors likely were not aware that daily confirmations should be produced for sweep funds. In 1999, the NFA auditors made notes about the fact that PFG could not record interest daily. The NFA auditors noted that PFG recorded a daily estimated accrual and reconciled interest income at the end of every month by using the bank statement.

Further, during each of the 2003, 2008 and 2009 audits, the NFA auditors accepted one daily confirmation as sufficient audit evidence of PFG's repos. The BRG Investigative Team found no evidence that NFA auditors obtained any additional daily confirmations during the 2003, 2008 or 2009 audits and no evidence that NFA auditors obtained any daily confirmations for repos during other audits.

The BRG Investigative Team found that for repo transactions, NFA auditors did not ask for any documentation except for the last day of the period being audited. This precluded the review of any intra-period repo transactions that took place during the periods as to permissibility of the investments and concentration limitations. Therefore, the NFA audits of PFG repos did not give reasonable assurance that PFG was complying with NFA rules regarding repos during the period.

B. Standards Related to Repurchase Agreements and Sweep Accounts

In light of the importance of similar issues, the SEC recently wrote: [60]

[59] NFA03353322-NFA03353368 (JAC Program 2010 FINANCIAL).

[60] 17 CFR Parts 229 and 249; Release Nos. 33-9143; 34-62932; Proposed rule on "Short-Term Borrowings Disclosure."

> [S]hort-term financing arrangements can present complex accounting and disclosure issues, even when market conditions are stable. Due to their short-term nature, a company's use of such arrangements can fluctuate materially during a reporting period, which means that presentation of period-end amounts of short-term borrowings alone may not be indicative of that company's funding needs or activities during the period. For example, a bank that routinely enters into repurchase transactions during the quarter might curtail that activity at quarter-end, resulting in a period-end amount of outstanding borrowings that does not necessarily reflect its business operations or related risks.

Auditing Standard ("AS") No. 15, *Audit Evidence*, prescribes that an auditor must plan and perform audit procedures to obtain sufficient appropriate audit evidence to provide a reasonable basis for his or her opinion. Regarding sufficiency, AS No. 15 notes that "as the risk increases, the amount of evidence that the auditor should obtain also increases."[61]

Certain CFTC rules do not only govern the end of the year balance sheet of FCMs, but also their ongoing activities throughout the year. For example, CFTC Rule 1.25 specifies permissible investments with customer funds, and it has concentration limits including asset-based, issuer-based, and now counterparty-based limits.

C. Recommendation Related to Repurchase Agreements and Sweep Accounts

19. NFA should enhance its procedures used in connection with NFA annual audits of FCMs that explains how to identify risk factors associated with cash transfers of segregated funds, including, the use of reverse repurchase agreements and sweep accounts.

D. NFA Initiatives Related to Repurchase Agreements and Sweep Accounts

With respect to the BRG Investigative Team's recommendations for additional protocols to identify risk factors, NFA management noted that it has periodically revised the steps in its audit modules testing the investment of customer segregated funds when it has become aware of new issues relating to permissible investments of these funds. NFA has always expected its auditors to identify investments of customer segregated funds that do not comply with the requirements of Rule 1.25, to follow-up with an FCM to confirm the non-compliance is promptly corrected, and to determine if the improper investment represents a material deficiency for the audit report.

However, as part of its financial surveillance work, NFA auditors review an FCM's current assets used for calculating net capital. It is likely that NFA auditors would encounter any unusual or specialized investments as part of the review. Whether in connection with financial surveillance or an audit, if an NFA auditor sees an unusual or specialized investment identified as a current asset, he or she is expected to follow-up with the FCM to learn more about the asset. Depending on the information received from the FCM and the materiality of the asset to the FCM's net capital, NFA auditors may

[61] AS No. 15, paragraphs 4-9.

conduct additional research to determine if the asset is allowable as a current asset for net capital. This research may include an investigation of the liquidity and pricing for the asset, and contacting other regulators to seek their experience with the asset type. If NFA determines that the asset is allowable, training on the testing of the asset will be provided to staff.

Finding X: NFA's Coordination Efforts with the CFTC Can be Improved.

A. Investigative Findings Related to NFA Coordination with the CFTC

As discussed in greater length in the Report of Investigation, the CFTC conducted an audit of PFG in 1999, which culminated in a settlement agreement between the CFTC and PFG in 2000. NFA, in fact, followed up with PFG in its 2000 audit to ensure that PFG was fulfilling the conditions of the CFTC settlement. While there was a reference in NFA's 2000 audit that NFA staff "teleconferenced with CFTC staff" to discuss the items in a CFTC report, NFA auditors who worked on the 1999, 2000, and 2001 audits of PFG did not recall significant coordination with the CFTC regarding the CFTC audit work.

In addition, the BRG Investigative Team found that NFA auditors learned about CFTC reviews or audits of PFG that occurred in 2009 and 2010 from PFG officials rather than from the CFTC itself. As discussed in greater detail in the Report of Investigation, in 2009, while NFA was conducting its 2009 audit of PFG, a former NFA senior manager was informed by O'Meara that the "CFTC was looking at the [PFG] U.S. Bank reverse repo account." However, this former NFA senior manager stated that she never learned the results of the CFTC review and did not recall any communication with the CFTC about the review. In 2010, this same former NFA senior manager was also informed by O'Meara that the CFTC was conducting an onsite anti-money laundering ("AML") review of PFG. As with the CFTC review of PFG's repo accounts, the former NFA senior manager stated that she did not recall having any conversations with CFTC about this matter and did not learn about the results of CFTC's review.[62]

B. Standards Related to NFA Coordination with the CFTC

As stated previously, the JAC Audit Program directs an auditor, during the audit planning stage, to "[c]onsult other Compliance Departments, Clearing Houses (Trade Practice, Market Surveillance, and Risk Management), NFA and SROs where the firm has membership privileges. Identify and document any material problems they have had with the subject firm which would affect the scope of our review."[63] While the BRG Investigative Team was unable to locate any other specific standard pertinent to this matter, sharing of information among agencies that regulate an FCM would lead to greater efficiencies on the part of both agencies.

C. Recommendation Related to NFA Coordination with the CFTC

20. NFA should consider how it can improve the flow of information, where appropriate, with the CFTC and SEC regarding NFA audits and/or reviews of FCMs.

[62] The BRG Investigative Team also did not find evidence that senior officials at NFA were apprised of these CFTC findings.

[63] NFA03353369-NFA03353391 at NFA03353371 (JAC Program 2010 GENERAL).

D. NFA Initiatives Related to NFA Coordination with the CFTC

NFA management indicated that they believed that, overall, there is significant coordination and communication between NFA and the CFTC, although primarily at higher levels. NFA shares its logs of audits with the CFTC and works closely with CFTC Division of Enforcement personnel on a routine basis.

Finding XI: NFA's Process of Obtaining Bank Confirmations in PFG Audits Has Been Improved.

A. Investigative Findings Related to Bank Confirmations

The BRG Investigative Team found that, until 2005, bank confirmations were not done routinely in every audit. The BRG Investigative Team also found that, historically, while the NFA auditors would look to "outside sources" to compare firm documents to, such as bank statements or carrying broker statements, those bank and other statements would be provided by the FCM itself. Therefore, with the exception of the bank confirmation process, while NFA auditors compared records to third-party documents, it only compared the third-party documents received from the firm.

The BRG Investigative Team further found that in all the audits over the years where NFA auditors sent confirmations to U.S. Bank, NFA auditors received confirmations in the mail that they were able to reconcile to the U.S. Bank statements supplied by PFG. In most years, NFA auditors added the ending bank statement balance to the repo balance that was reflected elsewhere on the U.S. Bank statement. The sum of the ending bank statement balance and the repo matched the confirmation.

In 2011, as described in detail in the Report of Investigation, NFA auditors received from U.S. Bank a confirmation statement indicating the balance for the PFG customer segregated account was $7,181,336.36. The bank confirmation was uploaded and scanned into NFA's system and the NFA staff auditor stated that she looked at the numbers for the PFG segregated account and "noticed that they did not match" the bank statement. She then stated that she "informed the [field supervisor] . . . that the numbers did not match."

The BRG Investigative Team found that NFA on the next business day received a "corrected" confirmation purportedly from U.S. Bank, which showed a balance of $218,650,550.96. This "corrected" confirmation later was found to be a forgery crafted by Wasendorf. The staff auditor stated that she uploaded this "corrected" confirmation into the NFA module software and noted that the bank confirmation now matched the U.S. Bank statement.

The field supervisor for the 2011 audit stated that she did not recall the staff auditor having any reaction to the $7 million confirmation and did not recall "any discussion at all among the auditing team about this issue." The manager on the audit stated that he was not aware during the course of the audit that there had been two confirmations or a "corrected" confirmation.

The BRG Investigative Team further found that, in 2012, NFA began utilizing the electronic confirmation process. In connection with the 2012 audit, NFA auditors filled out a form with confirmation.com that included all the balances that it needed to verify. NFA requested the balances of PFG's segregated bank accounts as of April 30, 2012. On July 2, 2012, NFA requested an electronic signature through confirmation.com from Wasendorf and on July 8, 2012, Wasendorf affirmatively responded to the electronic confirmation request. As a result of Wasendorf's electronic authorization, the system automatically sent the balance to U.S. Bank and U.S. Bank submitted the amount of the balance on July 9, 2012. Prior to the confirmation being received back from confirmation.com, which would have showed the discrepancy between the amount Wasendorf confirmed and the amount U.S. Bank confirmed, NFA became aware that Wasendorf had attempted suicide and confessed to the fraud.

B. Standards Related to Bank Confirmations

The JAC financial audit program described steps relating to the review of cash and securities. We found the JAC procedure to be as follows: [64]

> On a scope basis, obtain from each depository confirmation of bank balances as of the audit date. Either an original bank statement or direct confirmation with the depository may be used.

Under the JAC Audit Program, in most audit situations, an original bank statement could be an appropriate substitution for direct confirmation. This JAC Audit Program procedure also appeared in the NFA audit module because the NFA module only included instruction to "consider confirming balances on deposit with bank,"[65] which implied that some other audit evidence (such as a bank statement) was suitable audit evidence.[66]

The AICPA 's SAS No. 67, *The Confirmation Process*, became effective in 1992. SAS No. 67 describes situations where an original bank statement can be used in place of direct confirmation:[67]

> The lower the combined assessed level of inherent and control risk, the less assurance the auditor needs from substantive tests to form a conclusion about a financial statement assertion. Consequently, as the combined assessed level of inherent and control risk decreases for a particular assertion, the auditor may modify substantive tests by changing their nature from more effective (but costly) tests to less effective (and less costly) tests. For example, if the combined assessed level of inherent and control risk over the existence of cash is low, the auditor might limit substantive procedures to inspecting client-provided bank statements rather than confirming cash balances.

Neither JAC Audit program procedures nor the NFA modules included steps to maintain control over confirmation responses. As described in SAS No. 67:[68]

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[64] NFA03353324 (JAC Financial, Revised March 2010)
[65] Procedure #5 on the Net Capital module reads "Obtain / prepare a listing of the firm's current cash balances (operating, segregated and customer funds for Forex trading) as of the audit date. Consider confirming balances on deposit with bank." NFA00012930 (11-CEXM-239 Net Capital module).
[66] Per the NFA audit modules, bank statements are used for various audit tests. The NFA modules do not offer guidance on the form of the bank statements (i.e. original, fax, photocopy, on-line access) used for testing.
[67] AU 330.10.

> During the performance of confirmation procedures, the auditor should maintain control over the confirmation requests and responses. Maintaining control means establishing direct communication between the intended recipient and the auditor to minimize the possibility that the results will be biased because of interception and alteration of the confirmation requests or responses.

For example, an auditor can maintain control over the confirmation process by mailing the request to the bank and by instructing the bank to mail the response directly to the auditor. JAC Audit Program procedures, and likewise the NFA modules, also did not include steps to authenticate confirmation responses. Accepted practices provide that extended procedures may be necessary and require direct confirmation or other procedures. For instance, SAS No. 67 includes steps to authenticate confirmation responses in certain situations:[69]

> There may be situations in which the respondent, because of timeliness or other considerations, responds to a confirmation request other than in a written communication mailed to the auditor. When such responses are received, additional evidence may be required to support their validity. For example, facsimile responses involve risks because of the difficulty of ascertaining the sources of the responses. To restrict the risks associated with facsimile responses and treat the confirmations as valid audit evidence, the auditor should consider taking certain precautions, such as verifying the source and contents of a facsimile response in a telephone call to the purported sender. In addition, the auditor should consider requesting the purported sender to mail the original confirmation directly to the auditor. Oral confirmations should be documented in the workpapers. If the information in the oral confirmations is significant, the auditor should request the parties involved to submit written confirmation of the specific information directly to the auditor.

C. Recommendation Related to Bank Confirmations

21. NFA should continue in its efforts to electronically obtain daily segregation balances directly from all segregation depositories.

D. NFA Initiatives Related to Bank Confirmations

All NFA audits now utilize the electronic-confirmation process. In addition, in August 2012, NFA's Board of Directors also agreed that NFA would develop a daily segregation confirmation system that would require all depositories holding customer segregated and secured amount funds to file daily reports reflecting the funds held in segregated and secured amount accounts. NFA then would perform an automated comparison of that information with the daily segregation and secured amount reports filed by the FCMs to identify any material discrepancies. The system is currently being implemented in phases.

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[68] AU 330.28.
[69] AU 330.29.

APPENDIX A – LIST OF RECOMMENDATIONS

1. NFA should update and revise its audit training, guidance, planning and other audit modules to ensure its auditors conduct audits and examinations with appropriate professional skepticism that includes a questioning mind and a critical assessment of audit evidence, in particular with respect to reliance on representations of management regarding key risk areas.

2. NFA should establish protocols to ensure that appropriate levels of supervisory audit personnel spend sufficient time on-site to provide any needed support and supervision to audit personnel during audits of FCMs.

3. NFA should evaluate its hiring practices to ensure it employs auditors with diverse skill sets, which will expand NFA's knowledge base and improve NFA's ability to assess risk, conduct audits, detect and investigate wrongdoing and focus priorities.

4. NFA should assess the feasibility of establishing a rotation program with prominent accounting firms to allow for auditors from those firms to serve for prescribed periods of time at NFA in order for NFA auditors to gain valuable audit industry experience.

5. NFA should integrate event-driven programs into its ongoing training regime to ensure that NFA auditors are informed of lessons learned from events that occur in the financial industry, as well as specialized products and new industry developments that affect NFA audits.

6. NFA should update its policies and procedures to ensure more consistent, effective, and documented use of its Planning Module in connection with the financial review audits of FCMs.

7. NFA should develop mechanisms to ensure that the Planning Module is modified and updated on a regular basis to incorporate industry, regulatory, and other external factors, including *ad hoc* updates to incorporate lessons learned from significant events that occur in the financial industry.

8. NFA should update its modules for the audits of FCMs to incorporate specific and concrete steps to identify internal control risks in firms, including inquiries of appropriately qualified management, supervisory, and staff personnel; segregation of duties; inspection of entity documents and records; and observations of entity activities and operations.

9. NFA should work with JAC to monitor developments in auditing literature, including new pronouncements from the PCAOB, AICPA and COSO, and integrate those new pronouncements into NFA audit modules and other guidance, as appropriate.

10. NFA should evaluate how best to improve its audit process in order to ensure it includes review of regulatory problems that have surfaced but were not detected previously, and modify the audit modules as appropriate, to ensure that improvements are made to reflect the problems identified.

11. NFA should update its modules for the audits of FCMs to incorporate specific and concrete steps to obtain an understanding of risk factors in audits relating to the control environment at an FCM, including, among other things, a better understanding of the effects of the "tone at the top" of an organization (*see* PCAOB AU § 314.40-41), domineering management behavior, policies relating to appropriate business practices, knowledge and experience of key personnel, and resources provided for carrying out duties.

12. NFA should update its modules for the audits of FCMs to incorporate specific and concrete steps to develop an understanding of the qualifications of the CPA firm performing the FCMs' annual audit.

13. NFA should consider requiring FCMs that hold customer funds to consent to permitting the firm's CPA to meet and confer with NFA auditors, at the request of NFA, regarding the CPA's most recent audit and findings and, where appropriate and requested by NFA, provide NFA with any workpapers related to the audit. NFA also should consider updating its audit modules to require that it confer with the CPA of any FCM that holds customer funds prior to NFA's annual examination of the firm on the scope and coverage of the CPA's audit and any material findings.

14. NFA should consider the information obtained in discussions with the FCM's CPA (as described in the preceding recommendation) in planning and setting scopes in its annual examination. NFA also should consider whether it would be necessary to review any of the CPA's workpapers in setting the scopes in its annual examination.

15. NFA should update its modules for the audits of FCMs to incorporate specific and concrete steps to develop an understanding of the measurement and review of an FCM's financial performance, including analysis of the financial standing of the FCM and any reasons that management may be motivated to take inappropriate action to improve business performance or to alter the FCM's financial statements.

16. NFA should update its modules for the audits of FCMs, including possibly its anti-money laundering policies, to incorporate specific and concrete steps to obtain an

understanding of the sources of material capital contributions made by senior officials into the FCM over time.

17. NFA should develop specific guidance and support for staff auditors or field supervisors who encounter during the course of an audit, representatives of FCMs, or any NFA-member firm, who act in an intimidating, intransigent or uncompromising manner.

18. NFA should reinforce its existing policies and procedures to ensure that the reports and critical details of a BCC action against an FCM, or its principals, be shared with NFA auditors conducting audits of the FCM, as well as regulatory actions of the SEC, CFTC, FINRA, and others. NFA also should reinforce its existing policies and procedures to ensure NFA auditors examine material civil actions against an FCM as part of their assessment and audit planning process.

19. NFA should enhance its procedures used in connection with NFA annual audits of FCMs that explains how to identify risk factors associated with cash transfers of segregated funds, including, the use of reverse repurchase agreements and sweep accounts.

20. NFA should consider how it can improve the flow of information, where appropriate, with the CFTC and SEC regarding NFA audits and/or reviews of FCMs.

21. NFA should continue in its efforts to electronically obtain daily segregation balances directly from all segregation depositories.