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THE FUTURE OF CFTC: PERSPECTIVES ON CUSTOMER PROTECTIONS

HEARING

BEFORE THE

SUBCOMMITTEE ON
GENERAL FARM COMMODITIES
AND RISK MANAGEMENT

OF THE

COMMITTEE ON AGRICULTURE
HOUSE OF REPRESENTATIVES

ONE HUNDRED THIRTEENTH CONGRESS

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THE FUTURE OF CFTC: PERSPECTIVES ON CUSTOMER PROTECTIONS

WEDNESDAY, OCTOBER 2, 2013

HOUSE OF REPRESENTATIVES,
SUBCOMMITTEE ON GENERAL FARM COMMODITIES AND RISK MANAGEMENT,
COMMITTEE ON AGRICULTURE,
Washington, D.C.

The Subcommittee met, pursuant to call, at 9 a.m., in Room 1300, Longworth House Office Building, Hon. K. Michael Conaway [Chairman of the Subcommittee] presiding.

Members present: Representatives Conaway, Neugebauer, Austin Scott of Georgia, Crawford, Roby, Hartzler, Noem, Benishek, LaMalfa, Hudson, Davis, Lucas (*ex officio*), David Scott of Georgia, Vela, Enyart, Vargas, Walz, Negrete McLeod, and Costa.

Staff present: Debbie Smith, Jason Goggins, Kevin Kramp, Mary Nowak, Pete Thomson, Tamara Hinton, John Konya, and C. Clark Ogilvie.

OPENING STATEMENT OF HON. K. MICHAEL CONAWAY, A REPRESENTATIVE IN CONGRESS FROM TEXAS

The CHAIRMAN. Good morning. Well, thank you for joining us this morning as we continue our series of hearings on the future of the Commodity Futures Trading Commission. Today's hearing is focused on how to better protect customers in the futures marketplace.

I would like to extend a warm welcome to all our witnesses today, and your participation in today's hearing is invaluable as we work toward the reauthorization of the Commission and improving how it operates.

Constituents in Texas and Americans across the nation depend on well functioning financial markets to manage their businesses. In an increasingly globalized world, these markets provide access to financial tools that enable even the smallest firm to compete in any market. Therein, these markets, in particular, are essential to agricultural producers and manufacturers across the country as they use products, such as interest rate swaps and commodity hedges, to protect themselves from risk.

Yet, today, there is uncertainty across the commodities market in the wake of the collapse of two futures commission merchants, MF Global and PFG Best. In both cases, customers who thought their funds were held in safe segregated accounts suffered loss, financial losses. Since the failures of MF Global and the PFG Best, the futures industry has taken several important concrete steps to

improve the strength of the system overseeing segregated accounts. Among the most noteworthy of these changes is the daily electronic monitoring of customer account balances, a simple step that actually led to uncovering the fraud occurring at Peregrine Financial. Yet despite these improvements, no surveillance system is fool proof. There will always be risks inherent in trusting another person with your money. Honest people make mistakes, and bad people commit crimes. As mistakes occur, Members on this Committee must continue to refine the market surveillance systems, but when crimes occur, it is essential that our justice system acts deliberately and decisively to punish those who harm others and cast doubt on the safety of financial markets.

Our challenge is to put in place systems and processes to ensure mistakes are caught swiftly and wrongdoing is made exceptionally difficult. As we do so, we must examine whether the cost of new regulations outweigh the benefits to the marketplace. In particular, I know that Members of this Committee are interested in testimony about the CFTC's proposed rule on customer protections. Many of the farmers and ranchers who are supposed to be protected by this rule have expressed deep skepticism of it, which I share with them, because they believe the CFTC's proposal would significantly increase their hedging costs and ultimately limit their ability to manage their risks.

Improving customer protections in futures markets is a topic that Members on both sides of the aisle have been eager to explore for some time.

For many of our constituents, the failure of MF Global and PFG Best added a new worry to their already overcrowded plate of concerns. An essential part of our job as lawmakers is to figure out the best way to restore confidence in investors that funds will always be safe no matter what happens to other market participants.

I look forward to the testimony from our witnesses today, and some good conversation about what the industry has fixed so far, what problems still remain, and what legislative role this Committee will play in addressing those issues.

Again, I would like to thank our witnesses for their willingness to share their expertise with us. As well, I would like to thank all the Members of the Subcommittee for their continued diligence in these hearings to reauthorize the CFTC. We will produce a better legislative product because of our collective engagement on these issues.

[The prepared statement of Mr. Conaway follows:]

PREPARED STATEMENT OF HON. K. MICHAEL CONAWAY, A REPRESENTATIVE IN CONGRESS FROM TEXAS

Good morning, thank you all for joining us as we continue our series of hearings on the future of the Commodity Futures Trading Commission. Today's hearing is focused on how to better protect customers of the futures marketplace.

I would like to extend a warm welcome to all of our witnesses today; your participation in today's hearing is invaluable as we work toward reauthorizing the Commission and improving how it operates.

My constituents in Texas, and Americans across the nation, depend on well-functioning financial markets to manage their businesses. In an increasingly globalized world, these markets provide access to financial tools that enable even the smallest firm to compete in any market. Derivatives markets, in particular, are essential to agricultural producers and manufacturers across the country, as they use products

such as interest rate swaps and commodity hedges to protect themselves from unknown risks.

Yet today, there is uncertainty across the commodities markets in the wake of the collapse of two futures commission merchants—MF Global and PFG Best. In both cases, customers who thought their funds were held in safe, segregated accounts suffered devastating financial losses.

Since the failures of MF Global and PFG Best, the futures industry has taken several important, concrete steps to improve the strength of the system overseeing segregated accounts. Among the most notable of these changes is the daily electronic monitoring of customer account balances—a simple step that actually led to the uncovering of the fraud occurring at Peregrine Financial.

Yet, despite these improvements, no surveillance system is foolproof. There will always be risks inherent in trusting another person with your money—honest people make mistakes and bad people commit crimes. As mistakes occur, regulators and this Committee must continue to refine the market surveillance systems. But, when crimes occur, it is essential that our justice system acts deliberately and decisively to punish those who harm others and cast doubt on the safety of financial markets.

Our challenge is to put in place systems and processes that ensure mistakes are caught swiftly and wrongdoing is made exceptionally difficult. As we do so, we must examine whether the costs of new regulations outweigh the benefits to the marketplace.

In particular, I know that Members of this Committee are interested in testimony about the CFTC's proposed rule on customer protections. Many of the farmers and ranchers who are supposed to be protected by this rule have expressed deep skepticism of it—which I share with them—because they believe the CFTC's proposal could significantly increase their hedging costs and ultimately limit their ability to manage risk.

Improving customer protections in futures markets is a topic that Members on both sides of the aisle have been eager to explore for some time. For many of our constituents, the failure of MF Global and PFG Best added a new worry to their already overcrowded plate of concerns. An essential part of our job as lawmakers is to figure out the best way to restore confidence that an investor's funds will always be safe, no matter what happens to other market participants.

I look forward to the testimony from our witnesses today and a good conversation about what the industry has fixed so far, what problems still remain, and what legislative role this Committee will play in addressing those issues.

I'd like to again thank our witness panel for their willingness to share their expertise with us. As well, I'd like to thank all the Members of this Subcommittee for their continued diligence in these hearings to reauthorize the CFTC. We will produce a better legislative product because of our collective engagement on these issues.

With that, I'll turn it over to my friend and partner in these issues, Ranking Member Scott, for his opening remarks.

The CHAIRMAN. With that, I will turn to my friend and partner in these issues, Ranking Member David Scott for his opening remarks. David.

OPENING STATEMENT OF HON. DAVID SCOTT, A REPRESENTATIVE IN CONGRESS FROM GEORGIA

Mr. DAVID SCOTT of Georgia. Thank you, Chairman Conaway.

As always, I would like to join you and—first, turning on the mike. First, I would like to join you in warmly welcoming our distinguished witnesses and guests to our Subcommittee.

Today's hearing is one of the final pieces in our effort to prepare for the coming Commodities Exchange Act Reauthorization, and I look forward to a robust exchange of information regarding the protection of customers of futures commission merchants.

Of course, protection of market participants is one of the core functions of the CFTC. Unfortunately, it is in an area in which we have seen several startling lapses in oversight recently. Whether it is MF Global, Peregrine Financial, or most recently, the fines

against Vision Financial, which ironically, absorbed much of the portfolio of Peregrine upon its collapse, one has to ask questions about the structure of the current oversight system and its appropriateness for the way the markets currently operate.

That is not to say that the CFTC isn't working hard. They are working hard to ensure that customer funds are not commingled with company funds. However, the CFTC is being asked to provide oversight for markets that have grown exponentially, extraordinarily much larger over the last 10 years, and all the while attempting to implement a very complex and complicated new financial regulatory regime in Dodd-Frank, without a sufficient increase in the resources and funds and staff that they need to be made available to them to do the job. This is so important. We have to stress the appropriate appropriations level if we are going to put these demands on the CFTC. If the markets have grown as they have grown, then we have to grow their budget to match and make sure they have the resources to do their job.

And as such, the CFTC has been forced because of a lack of funds, because of a lack of standing, to become reliant on self-reporting and third-party auditing. That is not the way to go, because that only opens up room for error and outright criminal activity, and that is what we have seen.

And, unfortunately, when we see problems with the futures commission merchants, it negatively affects their customers and our constituents, like our farmers, our co-ops, our corporations, like Delta and Coca-Cola in my district, and ultimately all of the American people are affected, which is what brings us here today.

So, Mr. Chairman, again, I thank you for holding this important hearing. The perspectives of market participants and the CFTC's work in protecting customers in the FCMs will indeed be vital as we move forward. We must ensure that whatever regime the CFTC moves and puts into place works well with all involved in the market, reducing risk and protecting customer funds without significantly raising the price of doing business.

So, our examination here today will help in that respect. Thank you, I yield back the balance of my time.

The CHAIRMAN. I thank the gentleman.

I also recognize that the full Committee Chairman, Mr. Frank D. Lucas, is with us this morning. And Frank will be participating in the inquisition of our witnesses shortly.

The chair would request that other Members submit their opening statements for the record so that witnesses may begin their testimony and to ensure that there is ample time for questions.

I would like to welcome our panel of witnesses. I will introduce all six of them, and then we will start with Mr. Duffy.

Mr. Duffy is Executive Chairman and President of CME Group in Chicago, Illinois. We also have Mr. Daniel Roth, President and CEO with the National Futures Association from Chicago. We have Dr. Christopher Culp, Senior Advisor, Compass Lexecon from Chicago, Illinois. We have Michael J. Anderson, Regional Sales Manager of The Andersons, Inc., Union City, Tennessee, on behalf of National Grain and Feed Association, and we have James Koutoulas—is that close, James?

Mr. KOUTOULAS. Pretty close.

The CHAIRMAN. All right, Buddy. Esquire, President and Co-founder of the Commodity Customer Coalition, Chicago, Illinois, and Mr. Ted Johnson, the President of Frontier Futures, Inc., from Cedar Rapids, Iowa.

So, with that, Mr. Duffy, please begin.

STATEMENT OF HON. TERRENCE A. DUFFY, EXECUTIVE CHAIRMAN AND PRESIDENT, CME GROUP, INC., CHICAGO, IL

Mr. DUFFY. Thank you. Good morning, Chairman Conaway, Ranking Member Scott. I want to thank you for the opportunity to testify regarding customer protection in the futures industry.

CME, NFA, and others responded to the failures of MF Global and PFG by enhancing customer protections. These enhancements include: Daily segregated—segregation reporting by all FCMs; increased surprise reviews of segregation compliance; bimonthly reporting on investment of customer funds; periodic electronic confirmation of customer balances; daily feeds showing balances of cash and securities for all customer accounts at depositories; and CEO/CFO sign-offs on significant customer fund distributions.

The CFTC's proposed rules codify many of these initiatives. In addition, the CFTC has required gross margining at the clearinghouse level. This further protects customers from the kind of losses caused by MF Global and PFG.

Unfortunately, CFTC also has proposed a bad rule. This has justifiably raised concerns among participants in the agricultural markets and many Members of Congress. The rule would require FCMs to ensure that each customer's account is fully collateralized at all times. The problem is FCMs cannot accurately calculate customer margin requirements in real-time. Particularly, this means that—or practically, this means that customers will be required to double their margin requirements, or two, FCMs will be required to contribute very large sums as residual interest on behalf of their customers.

This rule will make the marginally profitable FCM business unsustainable for many firms that serve the agricultural community. Further, it may deprive not just FCMs but their customers' access to futures markets.

The residual interest rule is not necessary to protect customer funds. It's costs and the negative consequences outweigh any added protection. This over-collateralized—collateralization is unwarranted from a risk-management standpoint. No regulatory risk model assumes that all customers with margin requirements will fail to meet them.

The proposed ruled would drain liquidity and increase the cost of hedging financial and commodity risk, especially for farmers and ranchers using our markets. Unfortunately, the greatest impact of increased costs would be felt by the smaller and mid-sized firms that serve them. They may be driven out of business.

The unintended consequences is that this would actually increase systemic risk by concentrating risk among fewer firms. Ironically, the proposal would force customers to place more collateral with their FCM at the very time they may be trying to avoid fellow-customer risk or FCM misconduct.

We understand the Commission is considering phasing in the rule, possibly to mitigate the consequences I just described. A phase-in does not cure the problem, however. Instead, CME supports the FIA alternative. This approach would permit an FCM to calculate its required residual interest as of 6 p.m. on the first day after the trade date.

Now I would like to comment on adopting an insurance regime. Professor Culp concludes that the only workable insurance is likely private insurance. This insurance would be provided through a company owned by participating FCMs. There seems to be no commercial interest in providing insurance to individual customers or specific FCMs. He also explains that it is not feasible to have universal futures insurance mandated by the government similar to SIPC. Professor Culp points out that its funding, based on the FCM's gross revenues, would be highly regressive. Large FCMs would pay a lopsided share while their customers would likely benefit the least from the $250,000 coverage.

He concludes that the first year of funding, estimated at $25 million would not grow fast enough to reach the target level of $2.5 billion, until more that 5 decades later. So, without a government backstop, the plan would significantly underfund relative to potential private solutions, and we certainly would not support imposing the burden on the taxpayers.

Customer protection is the cornerstone of our industry. We have strengthened our approach, and we will continually consider ways to enhance the safety of customer property. At the same time, we strive to avoid unnecessary cost or change to market structure.

This will serve customer needs by making certain that we have deep pools of liquidity that allows customers to mitigate their risk.

I thank you, Mr. Chairman. I look forward to answering your questions.

[The prepared statement of Mr. Duffy follows:]

PREPARED STATEMENT OF HON. TERRENCE A. DUFFY, EXECUTIVE CHAIRMAN AND PRESIDENT, CME GROUP, INC., CHICAGO, IL

Good morning, Chairman Conaway, and Ranking Member Scott. I am Terry Duffy, Executive Chairman and President of CME Group.[1] Thank you for the opportunity to testify today regarding the protection of customer property in the futures industry.

CME Group Exchanges, the National Futures Association ("NFA") and other U.S. exchanges responded to failures at MF Global and Peregrine Financial Group ("PFG") by enhancing the protection of customer property held by futures commission merchants ("FCM"). These enhancements include:

- Daily segregation reporting by all FCMs,
- Increased surprise reviews of segregation compliance,
- Bi-monthly reporting on investment of customer funds,
- Periodic electronic confirmation of customer balances,

[1] CME Group Inc. is the holding company for five exchanges, CME, the Board of Trade of the City of Chicago Inc. ("CBOT"), the New York Mercantile Exchange, Inc. ("NYMEX"), the Commodity Exchange, Inc. ("COMEX") and The Board of Trade of Kansas City Missouri, Inc. ("KCBT") (collectively, the "CME Group Exchanges"). The CME Group Exchanges offer a wide range of benchmark products across all major asset classes, including derivatives based on interest rates, equity indexes, foreign exchange, energy, metals, agricultural commodities, and alternative investment products. The CME Group Exchanges serve the hedging, risk management, and trading needs of our global customer base by facilitating transactions through the CME Group Globex electronic trading platform, our open outcry trading facilities in New York and Chicago, and through privately negotiated transactions subject to exchange rules.

- Daily feeds showing balances of cash and securities for all customer accounts at depositories, and
- CEO/CFO signoffs on significant customer fund distributions.

These programs and rules mitigate the risk of, and augment the early detection of, the improper transfer of customer funds and the improper reporting of customer asset balances, and improve our ability to check compliance with CFTC requirements for the investment of customer funds. Our efforts to enhance our monitoring continue today through the use of an account balance aggregation tool, which facilitates analysis of all of the firm's customer account balances across all of its reporting banks. Timely, including daily, access to this additional information is enabling us to better direct our regulatory resources at risk-based reviews of customer balances at clearing members and FCMs and their activity with respect to those balances.

The CFTC's proposed rules codify many of these initiatives.[2] In addition, the CFTC has required gross margining at the clearing house level. This further protects customers from the kind of losses caused by MF Global and PFG.

Residual Interest

CME remains fully committed to protecting customers against the full range of FCM conduct that may cause customer harm. But it is important to weigh the costs and consequences of each "protective" measure against the benefits to customers. We believe that the CFTC's proposal respecting the required residual interest that must be maintained by FCMs in the customer segregated account will adversely impact customers and fundamentally change the way in which futures markets operate.[3] If a proposed "protective" measure is so expensive or its impact on market structure is so severe that customers cannot effectively use futures markets to mitigate risk or discover prices, there is no justification for implementing that measure. The proposal on "residual interest" fails this test. It has justifiably raised concerns among participants in the agricultural markets and many Members of Congress.

The rule would require FCMs to insure that each customer's account is fully collateralized "at all times."[4] FCMs cannot accurately calculate customer initial and variation margin requirements in real time. Practically, this means that customers will be required to double their margin requirements or FCMs will be required to contribute very large sums as "residual interest" on behalf of their customers. This rule will make the marginally profitable FCM business unsustainable for many firms that serve the agricultural community, and may deprive them and their customers of access to futures markets.

The residual interest rule is not necessary to protect customer funds. Its costs and negative consequences outweigh any added protection. This over-collateralization is unwarranted from a risk management standpoint. No regulatory risk model assumes that *all* customers with margin requirements will fail promptly to meet them. The proposed rule will unnecessarily drain liquidity and increase the cost of hedging financial and commercial risk especially for farmers and ranchers using our markets. Smaller and mid-sized firms that serve them will suffer the greatest impact of these increased costs, and may be driven out of business, leaving farmers and ranchers with fewer FCMs to facilitate their risk management goals. This will actually increase systemic risk by concentrating risk among fewer firms. Ironically, the proposal would force customers to place more collateral with their FCM—when they may be trying to actively avoid fellow-customer risk or FCM misconduct.

We understand the Commission is considering phasing in the rule, possibly to mitigate the consequences I just described. A phase-in does not cure the problem. Instead, CME supports the FIA alternative—that would permit an FCM to calculate its required residual interest as of 6 p.m. on the first business day after the trade date.[5]

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[2] NPR dated November 14, 2012 entitled, "Enhancing Protection Afforded Customers and Customer Funds held by Futures Commission Merchants and Derivatives Clearing Organizations." 77 *FR* 67866.

[3] CME Group filed comments to the CFTC's proposed rulemaking by letter dated February 15, 2013 from Kim Taylor, President, CME Clearing. (RIN 30–38–AD88).

[4] It would require each FCM to maintain "at all times" residual interest in its customer accounts sufficient to exceed the sum of all customer margin deficits.

[5] Comment Letter dated February 15, 2013 from Walt Lukken, President, FIA re: RIN 3038–AD88 *Enhancing Protections Afforded Customers and Customer Funds Held by Futures Commission Merchants and Derivatives Clearing Organizations,* 77 FED. REG. 67866 (November 14, 2012).

Bankruptcy Code

We believe that Congress could further enhance customer protections through amendments to the Bankruptcy Code. Potential amendments range from fundamental changes that would facilitate individual segregation of customer property to narrower revisions that would enhance a clearinghouse's ability to promptly transfer positions of non-defaulting customers. While amending the Bankruptcy Code is a significant undertaking, CME Group believes that modification to the bankruptcy regime in light of recent experience would benefit customers and the market as a whole.

Insurance

In the wake of MF Global and PFG, some have advocated establishing an insurance scheme to further protect futures customers and restore their confidence in our markets. Like other "protective measures," an insurance proposal must be analyzed in light of the costs and potentially limited benefits of such an approach.

To that end, CME Group, the Futures Industry Association ("FIA"), the Institute for Financial Markets ("IFM") and NFA engaged Compass Lexecon to study the costs and benefits of adopting an insurance regime for the U.S. futures industry.

It's notable that Professor Culp's written testimony concludes that the only possible workable insurance is likely *private* insurance provided through a company owned by FCMs that *choose* to participate. There seems to be no commercial interest to provide insurance to individual customers or on a FCM specific basis.

He also explains that a government-mandated universal futures insurance, similar to SIPC for securities is not feasible. Professor Culp points out that its funding—based on an FCM's gross revenues—would be regressive with large FCMs paying a lop-sided share, while their customers would likely benefit the least from the $250,000 coverage. He concludes that first year funding estimated at $25 million could barely cover an average loss caused by a default of small and medium FCMs.

Without a government backstop, the plan would be significantly under-funded relative to potential private solutions. And we certainly would not support imposing this burden on the taxpayers.

Conclusion

Customer protection is the cornerstone of our industry. We've strengthened our approach, and we will continually consider ways to enhance the safety of customer property. At the same time, we strive to avoid unnecessary cost or changes to market structure that would negatively impact the deep pools of liquidity our customers rely on to mitigate their risks.

The CHAIRMAN. Thank you, Mr. Duffy.

Mr. Roth.

STATEMENT OF DANIEL J. ROTH, PRESIDENT AND CHIEF EXECUTIVE OFFICER, NATIONAL FUTURES ASSOCIATION, CHICAGO, IL

Mr. ROTH. Thank you, Mr. Chairman.

I certainly think it is appropriate that the focus of today's hearing is customer protection issues, and certainly at NFA, that is what we focus on every day.

And as both the Chairman and Ranking Member pointed out in their opening statements, over the last 2 years, the failures, first at MF Global and then at Peregrine, certainly highlighted the need to strengthen the overall regulatory structure, and over the last 2 years, that is exactly what we have been working on. We have worked very closely with the CFTC and with the CME and with the entire industry. And just as Mr. Duffy reviewed, we have implemented—developed and implemented a wide range of regulatory enhancements that are described in my written testimony. And they are all important. They are all significant, but if I could focus your attention on one, it would be one that Mr. Duffy mentioned as well, and that is the daily confirmation of segregated balances.

So, for years and years, we have required FCMs to issue daily reports with either the NFA or CME regarding the amount of customer funds that they are holding. And then what we would do is, among other things, we would confirm those balances reported by the FCMs. We confirm those balances to outside sources, to the banks holding those funds as part of the annual examination process.

Well, clearly, that wasn't good enough. We had to find a better way to do this, and that is exactly what we have done. We have partnered with the CME, and together we developed this system that provides for the daily confirmation of segregated balances so that we receive reports from over 2,000 bank accounts confirming the balances that those banks are holding for customer segregated funds, and then we perform an automated comparison between the reports from the FCM and the reports from the bank to identify any sort of suspicious discrepancies.

So that daily confirmation process, along with all the other regulatory enhancements that we have made, clearly make the regulatory structure now significantly stronger than it was 2 years ago. And we are very gratified, really, that so many of the changes that we developed were incorporated into the CFTC's rule proposal, and we support so much of what is in the CFTC's rule proposal.

But as Mr. Duffy mentioned, there are other aspects of that rule that are very, very troubling. And let me just add a few points with respect to residual interest. What the Commission basically is proposing would require every FCM to assume that every customer is going to default on every margin call, and then there—make sure that they always have enough funds on hand to cover that possibility.

Well, let me make four quick points. Number one, this rule proposal on residual interest has absolutely nothing to do with either MF Global or Peregrine. Neither one of those cases had anything to do with customers not meeting margin calls.

Number two, this is first time in its 39 year history that the Commission has taken this position, that somehow the Act requires FCMs to assume that all customers will default on all margin calls. They have never taken that position before.

Number three, there is underlying assumption under this rule that all customers meet their margin calls with wire transfers and that nobody writes checks anymore, and that assumption is just not right, particularly in the ag sector, where the—both ag end-users and the FCMs that service them regularly accept checks as margin payment.

And fourth, just as Mr. Duffy mentioned, this proposal could have a devastating impact on both end-users and the FCMs that service the ag industry.

Like Terry said, either the customers have to put up a lot more money or the FCMs have to put up a lot more money or both, and the net effect is that, you are going to have fewer farmers using the futures markets to hedge their risk and fewer FCMs to service those customers. It is a bad idea and it shouldn't go forward.

Finally, Mr. Chairman, let me just mention the *Griffin Trading* case again. I have testified about it before. Over 30 years ago, the CFTC adopted a rule which provides that if an FCM bankruptcy

proceeding, that if there is a shortfall in customer segregated funds, the term *customer property* includes all of the assets of the FCM until the customers have been made whole, and I think that is a really good rule. It has been on the books a long time. It gives customer the—customers the priority and the protection they deserve.

But several years ago, a Federal district court cast some doubt about the validity of that rule. They issued a decision, which was later vacated, which questioned the Commission's authority to adopt that rule that they did.

Well, I think we have to address that and we have to eliminate that doubt. We have to eliminate that cloud of uncertainty. And I don't think that requires us to amend the Bankruptcy Code. And I don't think that requires us to have FCMs run around and get a multitude of subordination agreements from various creditors. Section 20 of the Act deals with FCM bankruptcy proceedings. I think we can amend section 20 of the Commodity Exchange Act to make very clear the Commission's authority to adopt the rule that it adopted, and we would be happy to work with staff to develop that language.

Mr. Chairman, thank you very much for the opportunity to testify, and I look forward to answering any questions.

[The prepared statement of Mr. Roth follows:]

PREPARED STATEMENT OF DANIEL J. ROTH, PRESIDENT AND CHIEF EXECUTIVE OFFICER, NATIONAL FUTURES ASSOCIATION, CHICAGO, IL

Chairman Conaway, Ranking Member Scott, Members of the Committee, thank you for the opportunity to testify at this important hearing. My name is Daniel Roth and I am the President of National Futures Association. As Congress begins the reauthorization process, customer protection issues should be front and center in everybody's mind. Customer protection is the heart and soul of what we do at NFA, and for years the futures industry had an impeccable reputation for safeguarding customer funds. Since Congress last considered reauthorization, though, that reputation has taken a serious hit. First at MF Global and then at PFG, customers suffered very real harm from shortfalls in customer segregated funds, the kind of harm that all regulators seek to prevent. Clearly, dramatic improvements had to be made. In the wake of MF Global and PFG, NFA has worked very closely with the CME, other self-regulatory organizations and the CFTC to bring about those improvements. In my testimony today I would like to describe some of the improvements that have already been made, discuss the CFTC's proposed customer protection rules and suggest changes to the Commodity Exchange Act that would strengthen customer protections in any FCM bankruptcy proceeding.

Regulatory Improvements

Daily Confirmation of Segregated Account Balances

For years, NFA and other SROs confirmed FCM reports regarding the customer segregated funds held by the FCM through traditional paper confirmations mailed to the banks holding those funds. These confirmations were done as part of the annual examination process. In early 2012 NFA began confirming bank balances electronically through an e-confirm process. That change led to the discovery of the fraud at PFG, but e-confirms were still done as part of the annual examination. We had to find a better way and we did.

We partnered with the CME and developed a process by which NFA and the CME confirm all balances in all customer segregated bank accounts on a daily basis. FCMs file daily reports with NFA and the CME, reflecting the amount of customer funds the FCM is holding. Through a third-party vendor, NFA and CME get daily reports from banks for the over 2,000 customer segregated bank accounts maintained by FCMs. We then perform an automated comparison of the reports from the FCMs and the reports from the banks to identify any suspicious discrepancies. In short, Mr. Chairman, the process by which we monitor FCMs for segregated fund compliance is now far ahead of where it was just 1 year ago.

We have recently expanded this system to also obtain daily confirmations from clearing firms and will expand it again by the end of the year to include clearinghouses as well.

FCM Transparency

One of the lessons we learned from MF Global is that customers should not have to study the footnotes to an FCM financial statement to find out how their segregated funds are invested or other financial information about their FCMs. We had to make it easier for customers to do their due diligence on financial information regarding FCMs. For years, NFA required FCMs to file certain basic financial information with NFA, and that information is now posted on NFA's website for customer review. The information includes data on the FCM's capital requirement, excess capital, segregated funds requirement, excess segregated funds and how the firm invests customer segregated funds. This information is displayed for each FCM and includes historical information in addition to the most current data. The display of FCM financial information on NFA's website began in November 2012 and so far these web pages have received over 25,000 hits.

MF Global Rule

All FCMs maintain excess segregated funds. These are funds deposited by the FCM into customer segregated accounts to act as a buffer in the event of customer defaults. Because these funds belong to the FCM, the FCM is free to withdraw the excess funds, but after MF Global, NFA and the CME adopted rules to ensure notice to regulators and accountability within the firm. Now all FCMs must provide regulators with immediate notification if they draw down their excess segregated funds by 25% in any given day. Such withdrawals must be approved by the CEO, CFO or a financial principal of the firm and the principal must certify that the firm remains in compliance with segregation requirements. This rule became effective on September 1, 2012.

FCM Internal Controls

NFA, CME and other SROs developed more specific and stringent standards for the internal controls that FCMs must follow to monitor their own compliance with regulatory requirements. In May 2013, NFA's Board approved an interpretive notice that contains specific guidance and identifies the required standards in areas such as separation of duties; procedures for complying with customer segregated funds requirements; establishing appropriate risk management and trading practices; restrictions on access to communication and information systems; and monitoring for capital compliance. NFA submitted the interpretive notice to the CFTC on May 22, 2013, for its review and approval.

Review of NFA Examination Procedures

NFA's Special Committee for the Protection of Customer Funds—consisting of all public directors—commissioned an independent review of NFA's examination procedures in light of the PFG fraud. The study was conducted by a team from the Berkeley Research Group ("BRG") that included former SEC personnel who conducted that regulator's review of the SEC's practices after the Madoff fraud. BRG's report was completed in January 2013. The report stated that "NFA's audits were conducted in a competent manner and the auditors dutifully implemented the appropriate modules that were required." The report, however, also included a number of recommendations designed to improve the operations of NFA's regulatory examinations in the areas of hiring, training, supervision, examination process, risk management, and continuing education. All of the recommendations of the BRG report have been addressed and, as a result, NFA has:

- Revised and beefed up its examination modules regarding segregated funds, capital compliance, internal controls and the exam planning process;
- Made staffing changes so that experienced managers and directors spend more time in the field for every examination;
- Increased its recruiting and hiring of more experienced examiners; and
- Made further improvements to its training programs.

Certified Fraud Examiner Training

At the end of the day, the examinations performed by SROs in the futures industry are not about crossing "T"s and dotting "I"s—they are about detecting violations of SRO rules—including anti-fraud rules. That is why we have greatly expanded our use of the training programs of the Association of Certified Fraud Examiners. Becoming certified as a fraud examiner involves extensive training, testing and continuing education requirements. In the last year over half of our staff has obtained

the certification and we are now requiring all of our compliance staff to obtain that certification.

Strengthening Customer Protections in FCM Bankruptcy Proceedings

Both the PFG and MF Global bankruptcies highlighted the need for greater customer protections to not only guard against the loss of customer funds but also in the event of an FCM's insolvency. As discussed above, NFA has made and continues to implement changes to enhance the safety of customer segregated funds and guard against a shortfall in customer funds in the event of any future FCM failures.

NFA believes, however, that Congress should consider a statutory change to strengthen customer protections and priorities in the event of a future FCM bankruptcy. Over 30 years ago the CFTC adopted rules regarding FCM bankruptcies. Among other things, those rules provided that if there was a shortfall in customer segregated funds, the term "customer funds" would include all assets of the FCM until customers had been made whole. Several years ago, a district court decision cast doubt on the validity of the CFTC's rule. That decision was subsequently vacated but a cloud of doubt lingers. Congress can and should remove that doubt about the priority customers should received if there is a shortfall in segregated funds and can do so by amending Section 20 of the Act. Section 20 gives the CFTC authority to adopt regulations regarding commodity brokers that are debtors under Chapter 7 of Title 11 of the *United States Code.* We would suggest an amendment to clarify the CFTC's authority to adopt the rule that it did. We believe there is a broad base of industry support for this approach and would be happy to work with Congress on specific proposed language.

CFTC's Proposed Customer Protection Rules

NFA worked closely with the CFTC staff in developing many of the regulatory improvements described above. The Commission also proposed its own changes to customer protection rules in a 107 page *Federal Register* release last year. Certain parts of the Commission's proposals have provoked strong opposition both from the industry and from end-users of the markets, particularly in the agricultural sector. As described below, NFA shares many of the concerns raised by others, but we fully support many of the Commission's proposals. For example, the Commission's proposed rules would:

- Require SROs to expand their testing of FCM internal controls and develop more sophisticated measures of the risks posed by each FCM;
- Require that FCM certified annual financial reports and reports from the chief compliance officer be filed within 60 days of the firm's fiscal year end;
- Require that an FCM that is undercapitalized provide immediate notice to the Commission and its DSRO; and
- Require each FCM to establish a risk management program designed to monitor and manage the risks associated with the FCM's activities.

Other provisions of the Commission's proposals, however, raise serious concerns, particularly with regard to the so-called "residual interest" issue. FCMs have always maintained an amount of its own capital in customer segregated accounts to act as a buffer for customers who fail to meet their margin obligations in a timely manner. This amount is often referred to as the FCM's "residual interest" in the segregated account. The Commission has now proposed that all FCMs must maintain at all times a residual interest sufficient to exceed the sum of all margin deficits that the customers in each account class have. Essentially, FCMs would have to assume that every customer will default on every margin call and maintain capital in the segregated account to cover that possibility.

Several points need to be made on this proposal. First, it has absolutely nothing to do with the problems encountered at either MF Global or PFG. Neither of those cases had anything to do with customers failing to meet margin calls. Second, this is the first time in the Commission's 39 year history that it has ever taken the position that the Act requires FCMs to assume that all customers will default on all margin calls. Third, the underlying assumption that in this day and age no customers meet margin calls by writing checks is wrong. Agricultural hedgers frequently meet their margin calls with checks. Fourth, the impact of this proposal could be devastating for both agricultural end-users and the relative handful of FCMs that service those customers. Customers will have to post much more margin funds with their FCMs or the FCMs will have to maintain much more capital in their business. Either way, there will be fewer customers using futures markets to hedge and fewer FCMs handling their accounts. This proposal does not just fix something that is not broken, it threatens to do real harm to a longstanding system that has worked well for both customers and the markets.

The Commission has also proposed new requirements for SROs, most of which we support. However, the Commission's proposals blur important distinctions between the annual examinations of FCMs performed by CPAs and those performed by SROs. Each year an FCM must have a certified financial audit performed by a CPA. The CPA issues a report expressing an opinion with respect to the FCM's financial statements or issues an Accountant's Report on Material Inadequacies. The SRO examination, on the other hand, focuses on FCM compliance with the rules of the CFTC and the SRO. Certainly, there are areas of overlap between the two examinations but there are also marked differences in focus and purpose. The Commission proposes that an SRO apply Generally Accepted Auditing Standards to every aspect of its FCM examination, not just in those areas where the SRO and CPA exams overlap. This is overbroad and will add unnecessary costs and burdens to the examination process.

Customer Account Insurance Study

The failures of MF Global and PFG have generated renewed calls for some form of customer account insurance. Abstract discussions of this question do not help answer the two key questions: what type of insurance would be available and what would it cost. To answer those questions NFA joined with FIA, CME and the Institute for Financial Markets to sponsor the study being conducted by Dr. Christopher Culp, who is also a witness at today's hearing. Dr. Culp is awaiting pricing proposals from London reinsurance companies that would be part of a private sector solution.

Dr. Culp's research on this issue has been thorough and methodical. Based on his data, we would agree with his preliminary conclusions that for the vast majority of customers at the larger FCMs various forms of customer account insurance would be of little or no interest and that, given the size of these larger customers, the cost of a mandatory insurance program for all customers of all FCMs would be cost prohibitive, whether sponsored by the government or by the private sector. Dr. Culp's research thus far, though, indicates that for smaller FCMs with customers who maintain smaller balances there may be a voluntary private sector solution. Ultimately, the viability of that option will depend on the price quotes for reinsurance and on the demand for the product among smaller FCMs and their customers. We look forward to Dr. Culp's final report.

Conclusion

Detecting and combating fraud is central to our mission. No system of regulation can ever completely eliminate fraud, but we must always strive for that goal. The process of refining and improving regulatory protections is ongoing and the initiatives outlined above do not mark the end of our efforts. We look forward to working with Congress, the CFTC, SROs and the industry to ensure that customers have justified confidence in the integrity of the U.S. futures markets.

The CHAIRMAN. Thank you, Mr. Roth.

Dr. Culp.

STATEMENT OF CHRISTOPHER L. CULP, PH.D. SENIOR ADVISOR, COMPASS LEXECON, CHICAGO, IL

Dr. CULP. Excuse me, Chairman Conaway, Ranking Member Scott, other Members of the Committee, thank you very much for the opportunity to appear here today.

In December 2012, Compass Lexecon was engaged by CME, Futures Industry Association, NFA, and the Institute for Financial Markets to conduct an analysis of the potential benefits and costs of a customer asset protection insurance scheme of some kind that would apply to customers of U.S. futures commission merchants. I was the director and am the director of the study, and I am pleased to give you a progress report today on where we stand with the study, as well as offer some preliminary conclusions based on what the data and our discussions with market participants have thus far demonstrated.

Just to be clear, the risk that we are contemplating would be potentially covered by customer asset insurance is the risk that an

FCM failure would result in losses of customer assets if the FCM is undersegregated when it fails. In other words, the customer assets actually at the FCM are below the liabilities to customers of the FCM. That can occur for two reasons. One would be the misfeasance or malfeasance, as occurred, for example with MF Global and Peregrine. Another concern of some market participants is that so-called fellow-customer risk could impose undersegregation related losses. Fellow-customer risk occurs when one or more customers of the FCM face significant losses, miss a margin call, and that results in a deficiency in customer funds, that, in turn, results in asset losses for the other non-defaulting customers.

When evaluating the potential benefits of any kind of customer insurance regime, you have to keep in mind two things: The insurance doesn't exist in isolation, so the benefit of insurance has to be considered both with respect to the cost and to the probability that the underlying risk event will actually occur. I am not here to discuss these various other enhanced protections that have occurred since MF Global, but these protections that the other panelists are all discussing are relevant because, to the extent these additional protections are working to reduce the risk that there is an undersegregation at the time of an FCM failure, the value of insurance becomes potentially less with respect to its potential cost.

A significant objective of our study has been to try to estimate or quantify the cost of alternative insurance scenarios. Specifically, we considered four scenarios. Three private scenarios. First, direct provision of customer insurance by primary insurance companies. Second, direct provision of customer insurance to FCMs, on FCM-by-FCM basis. The third scenario is an industry risk retention group in which a group of FCMs collectively capitalize an insurance company that provides insurance to the customers of the participating FCMs. Those FCMs would retain and bear some of the first loss exposure in the event that there is an FCM failure, but reinsurance would then provide the primary source of capital on top of that first loss layer.

The final scenario we considered is a mandated, government mandated universal SIPC-like structure, in which every customer of U.S. futures commission merchant would receive up to $250,000 in insurance coverage. In return, that coverage would be funded by a SIPC-like investor protection fund for futures that is paid for by, under the current proposal, 0.5 percent of the previous year's gross annual revenues from futures of each and every U.S. FCM on a mandatory basis, and that would be a target funding level for the fund of $2.5 billion.

To facilitate the analysis of the three private scenarios, we have engaged for the better part of a year in a comprehensive data collection and analysis and empirical exercise, in which case we obtained customer level data from FCMs. We contacted a number of FCMs and received responses from six, two large, two medium, two small. We consider these broadly representative. We then worked with CME Group to conduct stress tests of this information and data so that we could examine what kind of customer assets might be at risk if an FCM happened to file during catastrophic market conditions.

We then showed summary analyses from those results to about ten potential interested insurance and reinsurance companies. All of them remain interested at this point. We do not have quotes or indicative cost estimates from any of them, but we are awaiting those and will provide them with the final study to this Committee when it is completed.

We can, however, offer several preliminary observations. First, as Mr. Duffy mentioned, we received no indication of interest in the direct provision of the FCM level or customer level insurance from insurance market participants. We have, however, received interest in the reinsurance aspect for a voluntary opt-in risk retention group. Our analysis also suggests that a government mandated universal coverage scheme could potentially suffer from significant drawbacks and concerns, one of which is that the vast bulk of the benefit of retail-oriented kind of investor protection fund would accrue benefits to the customers that are not bearing a proportional amount of the cost.

For example, in 2012, the average amount of assets on deposit at small and medium FCMs was about $100,000 in our data sample, as compared to about $25 million at large FCMs, and yet the large FCMs would be responsible for bearing a disproportionate amount of the cost. In addition, the fund would accrue money over time very slowly at about $25 million a year, using 2012 numbers, and it would virtually necessitate a government backstop to close the gap to the $2.5 billion funding level.

Finally, it would crowd out and discourage innovative market solutions, like the retention group, and it would essentially freeze a mandated structure in place and complicate the ability of voluntary solutions to close the gap. And I will be happy to cover any additional materials you have during the questions. Thank you for your time.

[The prepared statement of Dr. Culp follows:]

PREPARED STATEMENT OF CHRISTOPHER L. CULP, PH.D., SENIOR ADVISOR, COMPASS LEXECON, CHICAGO, IL

Chairman Conaway, Ranking Member Scott, and other Members of the Committee, thank you for inviting me to appear today. My name is Christopher Culp. I am a Senior Advisor with Compass Lexecon (a consulting firm that applies the principles of economic analysis to legal and regulatory issues), an Adjunct Professor of Finance at The University of Chicago's Booth School of Business (where I have taught MBA courses since 1998 on subjects including derivatives and insurance), and a Professor for Insurance at the University of Bern in Switzerland. I have a Ph.D. in finance, have authored four books and coedited two books on derivatives, insurance, structured finance, and risk management, have published numerous articles on those same topics, and have provided consulting services in these areas for the last 19 years.

In December 2012, Compass Lexecon was engaged by the CME Group ("CME"), Futures Industry Association ("FIA"), Institute for Financial Markets ("IFM"), and National Futures Association ("NFA") (collectively, the "Sponsors") to conduct a study of how customer asset protection insurance ("CAPI") might work in the U.S. futures industry and to evaluate the economic benefits and costs of alternative CAPI approaches (the "Study"). Before I give you a report on our progress, I begin by providing some background and context for the Study.

Background

The U.S. futures industry has been in the business of providing risk-management products and solutions to customers since the mid-19th Century. Typical futures customers include commercial entities like grain elevators, cooperative associations of farmers, non-financial multinationals, asset managers, commodity pool operators,

proprietary trading firms, and retail traders. Many of these futures market customers use futures and options to manage the risks that they face in their primary businesses in order to stabilize their costs and insulate themselves from swings in market prices that could give rise to catastrophic losses.

Futures customers execute their transactions through futures commission merchants ("FCMs"). Those transactions are cleared by central counterparties ("CCPs") like CME. CCPs function as the counterparty of record for all futures transactions and guarantee the performance on all trades. CCPs manage their risk exposures to trading counterparties in part by limiting their direct credit exposures only to "clearing members." Although all futures customers execute their transactions through FCMs, only some FCMs are CCP clearing members. Any trades executed by non-clearing FCMs must be guaranteed by a clearing FCM.

In order to provide trustworthy and safe risk-management solutions to customers, FCMs and CCPs must manage their own risks, preserve the integrity of the marketplace, and offer a risk-management solution in which market participants have confidence. In that regard, the U.S. futures industry has a long track record of successfully navigating a wide variety of market disruptions and high-profile defaults like Drexel Burnham Lambert, Refco, and Lehman Brothers.[1] The effectiveness of the futures trading risk-management system is largely attributable to several guiding principles that have been in place since the turn of the 19th century.

The first guiding risk-management principle in futures markets is that all trading participants must post a performance bond before entering into a new position and must maintain a required minimum margin amount throughout the life of an open trade. These minimum "initial margin" requirements are generally set to cover 99 percent of potential price changes over the time the CCP expects it would take to close out or hedge a losing position, which, for most products, is a day or less. Customers must deposit margin with their FCM(s), non-clearing FCMs must deposit margin with their clearing FCMs, and clearing FCMs must deposit margin with CCPs. Customer margin required by FCMs must be at least equal to and is usually higher than margin required by CCPs from FCMs.

The second guiding risk-management principle is that all open positions are marked to market twice daily. Depending on the direction of market movements, the process of marking open positions to market may create an obligation for customers to provide additional margin to FCMs or CCPs or may result in a credit to customers for their trading profits. Customers with gains may withdraw their profits daily. As a practical matter, however, many customers and non-clearing FCMs choose instead to leave their profits on deposit in order to maintain excess assets above margin requirements as a buffer to avoid the risk of being under-margined in the future, to reduce the hassle and cost of frequent funds transfers, or because they lack the operational capabilities to engage in daily account sweeps.

In the event that a clearing FCM cannot cover its payment obligations to a CCP, the defaulting FCM's margin and other eligible financial assets are used by the CCP to cover any losses resulting from the liquidation of the defaulting FCM's open positions and the liquidation or transfer of the FCM's customer positions. Any additional losses are absorbed by other financial safeguards, such as the mutualized clearing default guaranty funds maintained by CCPs. No FCM default to date has ever resulted in any losses to a U.S. CCP's clearing default fund.

A third risk-management principle underlying U.S. futures markets is the protection of customer assets held by FCMs, which include assets on deposit to satisfy customer margin requirements and any excess assets. Since 1974, Commodity Futures Trading Commission ("CFTC") regulations (and Commodity Exchange Authority regulations before that) have required FCMs to segregate customer assets from FCMs' own funds and to recognize those segregated assets as the customers' property.

Although customer assets are segregated from an FCM's assets, most customer assets are legally and operationally commingled in customer pools or omnibus accounts—one for customers trading futures and options on U.S. exchanges (*i.e.,* segregated or § 4d accounts), and another for customers trading on foreign boards of trade (*i.e.,* foreign-secured or § 30.7 accounts).[2] For both types of customer pools, FCMs must maintain sufficient funds to cover all of their customer obligations. In other words, assets in an FCM's customer pools must equal or exceed the customer

[1] All of these firms failed for reasons unrelated to their U.S. futures businesses, and their customer funds remained properly segregated at all times.

[2] Customer assets on deposit to support cleared over-the-counter derivatives are subject to a different segregation regime in which customer collateral is legally segregated but operationally commingled.

liabilities in those pools. When that does not occur in either or both pools of customer funds, the FCM is said to be "under-segregated."

One of the main benefits that segregation requirements provide is to make it easier for CCPs to manage the defaults of clearing FCMs that fail as a result of losses in their house trading accounts or for reasons unrelated to their futures trading activity. In those situations, the customer accounts[3] of the defaulting FCM can be transferred very quickly to non-defaulting FCMs or liquidated with no resulting loss to customers, and no significant ongoing disruption to customers' trading activities. This approach has worked well in practice over time.

Customer Assets at Risk

U.S. futures CCPs have a solid track record of managing FCM defaults with regard to the risk exposures of non-defaulting clearing members and mutualized CCP default funds. Nevertheless, customers have in the past several years experienced major losses arising from defaults of individual FCMs. Such losses can occur for two different reasons.

First, customer losses can arise if an FCM defaults as a result of misfeasance or malfeasance (*e.g.,* fraud, embezzlement, misappropriation of customer funds, and operational failures). Prior to 2007, such losses were generally small. For example, a study of customer asset risk conducted by NFA in 1986 found that between 1938 and 1985, less than $10 million of customer assets were lost as a result of defaults by FCMs that were under-segregated.[4] The failures of MF Global in October 2011 and Peregrine Financial Group in July 2012, however, involved substantial amounts of under-segregation losses realized by the customers of those firms.[5] In particular, the failure of MF Global has heightened customers' awareness of their exposure to under-segregation risk. Those concerns were a significant reason that the Sponsors commissioned the Study.

Second, futures customers are exposed to "fellow-customer risk." If one or more customers of an FCM incur significant losses and fail to honor their margin calls, a shortfall in customer segregated funds may result, in which case non-defaulting customers may not receive all of their funds back. Such fellow-customer losses arise when several situations occur at the same time: (i) one or more customers of the FCM must experience losses in excess of the margin they have already deposited—*i.e.,* market conditions must be so severe that the resulting losses exceed the target 99 percent coverage level underpinning initial margin requirements; (ii) some of those customers with large losses must be financially unable to honor their resulting payment obligations to the FCM; and (iii) the FCM must lack the financial resources to cover the defaulting customer payment(s), thereby forcing the FCM into default. The simultaneous occurrence of all three of these situations is highly unlikely.

In more than a century of U.S. futures trading, only one situation has arisen in which customers actually lost money as a result of fellow-customer risk exposures. In December 1998, a customer of Griffin Trading entered into positions on Eurex that generated a $10 million loss overnight. Griffin transferred funds to its clearing FCM from its foreign-secured customer accounts to cover the customer's losses. But those losses grew larger later the same day, and, when Griffin could not cover the margin calls arising from those additional losses, it filed for bankruptcy. As a result, Griffin's non-defaulting customers experienced losses resulting from Griffin's inability to cover the losses of its defaulting customer.[6] All of the fellow-customer losses at Griffin arose from its foreign-secured customer accounts (*i.e.,* customer assets related to trading on foreign boards of trade). The U.S. futures customer segregated accounts were transferred intact, and no Griffin customer trading only U.S. futures experienced any fellow-customer losses.

A handful of other situations have occurred in which a failure of one or more customers of an FCM to meet margin calls has resulted in the FCM's under-segregation and forced it into default. Other than Griffin Trading, however, none of these other defaults resulted in actual fellow-customer losses. For example, three customers failed to meet a total of $26 million in margin calls made by Volume Investors Corp. ("Volume") in 1985. Volume could not cover the payment obligation and thus de-

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[3] I henceforth use the term "customer accounts" to refer collectively to both segregated § 4d and foreign-secured § 30.7 accounts.

[4] National Futures Association, *Customer Account Protection Study* (November 20, 1986).

[5] The failure of Sentinel Management Group in August 2007 also involved losses of customer funds. Sentinel, however, was not a traditional FCM but rather was registered as a FCM so that it could hold other FCMs' customer funds. Sentinel thus was more similar in its operations to an investment company than a FCM.

[6] *See, e.g., In Re: Griffin Trading Company,* 245 B.R. 291 (Bankr. N.D. Ill. 2000), and *In Re: Griffin Trading Company* (7th Federal District, Northern Illinois), No. 10–3607 (June 25, 2012).

faulted to its CCP, The Commodities Exchange ("COMEX"). As a result of other assets held by Volume, recoveries by Volume's receiver from the original defaulting customers, and a payment by Volume's chief executive, none of the non-defaulting customers of Volume realized any losses.[7]

Nevertheless, fellow-customer risk remains a concern amongst many futures trading customers. Such concerns persist in part because customers do not feel that they can monitor the risk to which they are exposed through their fellow-customers' trading activities. Customers are, of course, free to choose their FCM(s) based on reputation and their customer risk monitoring capabilities. As a practical matter, however, only very large customers tend to do so.

Customer Asset Protection Insurance

Following the customer asset losses at MF Global and Peregrine, market participants and the CFTC have implemented numerous changes in how customer assets are protected. I am not here to discuss those changes today, but I do urge the Committee to take them into account when considering the issue that I *am* here to discuss today (*i.e.,* CAPI).[8] The net value of CAPI depends on the other protections in place to reduce the risk of customer asset losses. To the extent those other safeguards are working properly, insurable customer asset losses should be extremely rare occurrences, which, all else equal, reduces the value of CAPI.

The benefit and value of CAPI—like any other form of insurance—must be carefully weighed against its costs. In general, the price or premium that insurance companies charge policy holders in a competitive marketplace is the sum of (i) the average amount of claims the insurer expects to pay, (ii) the cost to the insurer of providing the coverage (including the cost of any reinsurance), and (iii) the insurer's profit margin. As such, a typical purchaser of virtually any kind of insurance should expect to lose money on average. Even if the customer's actual losses and claims payments are exactly equal to the customer's expected loss, the customer still has to pay the *total* premium, which, as noted, includes provisions to cover the insurer's costs, the cost of reinsurance, and the like.

That insurance purchasers have an expectation of losing money does not mean insurance has no value to purchasers. The policy limit, after all, is much higher than the expected or average claim. Insurance purchasers thus are willing to incur relatively small costs (*i.e.,* premium based on expected or average losses) in states of the world when an insured loss has not occurred in order to eliminate or reduce much larger potential losses in states of the world when an insured loss has occurred. The value of CAPI to customers thus depends both on the cost of the coverage and the amount of coverage relative to expected or average losses.

Another important determinant of the value of insurance is the amount of the deductible, or what insurers call the "first-loss retention." Insurance and reinsurance companies consider a first-loss retention of critical importance because it helps align the risk-management incentives of the policy holder with the insurance provider. Because the insurance company cannot perfectly observe the risk-management decisions and activities of policy holders, the first-loss retention gives policy holders an incentive to manage their own risks in order to avoid high-frequency, low-severity losses below the deductible. Naturally, the lower the first-loss retention, the higher is the policy premium.

In the context of CAPI, the first-loss retention is a challenge because the potential customer beneficiaries of CAPI do not directly control the process by which under-segregation and fellow-customer risk are managed. Forcing customers to bear the first-loss through a deductible is highly unlikely to influence the risk-management decisions of the FCMs that actually monitor and control those risks.[9]

The Insurance Scenarios

After Compass Lexecon was engaged by the Sponsors in December 2012, we first worked with the Sponsors to articulate several different CAPI scenarios that could then be shown to various insurance and reinsurance industry participants for the purpose of estimating the costs of privately provided CAPI under those different scenarios.[10] We articulated three private, voluntary, opt-in CAPI scenarios, and we also have considered a fourth scenario involving mandated, universal CAPI coverage.

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[7] CFTC, *Release 2586–86,* Docket #85–25 (July 29, 1986), at *http://www.nfa.futures.org/BasicNet/Case.aspx?entityid=0002121&case=85-25&contrib=CFTC*.

[8] Our Study will include an Appendix that summarizes the recent changes in detail.

[9] True, the existence of CAPI with no customer deductible will make customers indifferent about the risk-management practices of their FCMs, but, as I noted earlier, that is essentially already the case even in the absence of CAPI.

[10] We realize that possibilities for CAPI exist beyond the scenarios we defined. Nevertheless, we had to define several specific scenarios in order to facilitate consistent comparisons of costs

The first private, market-based CAPI scenario we defined is CAPI provided directly by primary insurance carriers to individual futures customers. Yet, no insurance market participant with whom we have spoken has expressed any interest in underwriting CAPI directly to end customers because customers seem unlikely to agree to a deductible, which is incompatible with virtually all traditional insurance markets. In addition, a customer-level deductible would not serve its usual purpose in mitigating moral hazard.[11] Insurers also indicated that, apart from the deductible issue, direct customer-by-customer CAPI likely would be very costly to administer and underwrite, which would lead to higher premiums than many futures customers might be willing to pay.

In the second scenario, FCMs could attempt to procure insurance on a one-off, FCM-by-FCM basis. For example, if a sole FCM wishes to provide $250,000 of CAPI to all of its 1,000 customers, the FCM would want to buy a total of $250 million in insurance with its customers as the named beneficiaries. Suppose an insurer agreed to provide $200 million in coverage in excess of a $50 million first-loss retention or deductible. The CAPI only would be triggered when the FCM fails, however, in which case the FCM would not have unencumbered access to the funds it would need to pay the first $50 million in customer CAPI claims. So, for this scheme to work, the FCM would have to pre-fund the $50 million deductible in a manner that insulates those funds from the general assets of the bankrupt estate so that the $50 million is available solely to fund the first $50 million in CAPI payments (with the insurance covering the next $200 million in CAPI claims). It is possible to do this (*e.g.,* through the use of captives or protected cell companies), but most insurance market participants with whom we spoke viewed such alternatives as cumbersome, unlikely to be profitable on an FCM-by-FCM basis, and, hence, unattractive.[12]

Our third scenario is an industry risk retention group ("RRG") in which a licensed primary insurance company is capitalized and owned by FCMs that wish to participate. Customers of the participating FCMs would be eligible for CAPI coverage that would be provided directly by the RRG. The participating FCMs would contribute capital that, together with CAPI premiums paid by customers, would fund a first-loss retention for the aggregate risk exposure of all customers across all participating FCMs arising from under-segregation or fellow-customer risk. The RRG would then purchase reinsurance for any CAPI payments in excess of the RRG's first-loss retention.

For example, a RRG might be formed by five or six FCMs to provide CAPI coverage to all customers of those participating FCMs. If the expected or average loss of the RRG based on the under-segregation and fellow-customer risks of the participating FCMs is $50 million, the participating FCMs would be required to deposit sufficient capital such that the paid-in capital plus premiums received from customers for their CAPI coverage would total $50 million. The RRG then could secure about $250 million of reinsurance in excess of the first-loss layer of $50 million. Customers of the participating FCMs thus would have up to $300 million available to cover under-segregation or fellow-customer losses. The first $50 million of customer claims would be paid out of the RRG's assets (including FCM-contributed capital and customer-paid premiums), and the next $250 million would be paid by the reinsurers of the RRG. Such a structure could also involve sub-limits for customers based on their size—*e.g.,* small customers would be covered for losses up to $50,000, whereas large customers would have claims limited to payments of up to $500,000.

In addition to providing CAPI protection to customers, the RRG provides a mechanism by which customers could be reimbursed for some or all of their indemnified losses very quickly even if their actual assets were frozen in the defaulted FCM's bankruptcy estate. For example, the RRG could obtain a line of credit to cover some or all of the payments owed to customers of a defaulting participating FCM that would be secured by the RRG's capital and the reinsurance receivable. Customers would thus receive a very rapid payment, and the eventual reinsurance payment to the RRG would be used to pay down the line of credit.

The industry RRG scenario is very similar in many important respects to the proposal put forth by the Commodities Customer Coalition ("CCC"), a nonprofit organi-

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provided by (re-)insurers. Otherwise, too many specific solutions might have been proposed that would have rendered cost comparisons impossible.

[11] If there is an alternative solution that does not expose FCMs to first-loss risks, we would recommend skepticism and suspicion for the aforementioned reasons.

[12] This does not preclude the possibility that some insurers and FCMs eventually could structure such a CAPI program. For purposes of the Study, however, interest in this scenario was too limited for us to get any meaningful feedback from insurers on costs and pricing.

zation formed in response to the bankruptcy of MF Global.[13] There are a few exceptions, however, between the RRG proposal we presented to reinsurers and the CCC proposal. For example, the RRG scenario we are reviewing with reinsurers is based solely on FCMs as owners, capital providers, and absorbents of losses in the first-loss layer. The CCC proposal, by contrast, contemplates that the RRG would also be owned and capitalized by commodity trading advisors, commodity pool operators, and introducing brokers.

Progress of the Study

In order to provide (re-)insurers with sufficient information for them to respond with meaningful indicative premium quotations for the three private, voluntary opt-in CAPI scenarios, we undertook a comprehensive empirical analysis of customer assets exposed to under-segregation or fellow-customer risk. Although aggregate data on customer assets reported on an FCM-by-FCM basis was readily available through the CFTC and the two Designated Self-Regulatory Organizations ("DSROs")—*i.e.,* CME and NFA, both of which are Sponsors of this Study—these data alone are not sufficient because FCM-level data only reveal total customer assets of the FCM and do not indicate customer-specific assets at risk. So, in February 2013, we contacted ten U.S. FCMs (ranging from very large banking institutions to smaller, specialized FCMs) and asked them to provide customer-level position and asset data for each month-end in 2012.[14] Of those ten FCMs, six (the "Contributing FCMs") provided usable data.

The six Contributing FCMs that responded to our request are broadly representative of the U.S. futures industry. Two of the FCMs were "Large FCMs" with $5 billion or more in customer assets and $1 billion or more in Adjusted Net Capital at year-end 2012. Another two of the Contributing FCMs were "Small FCMs" with less than $1 billion in customer assets and less than $100 million in Adjusted Net Capital at year-end 2012. The other two FCMs were "Medium FCMs" with between $1 and $5 billion in customer assets and between $100 million and $1 billion of Adjusted Net Capital. We completed our collection and preparation for subsequent analyses of the data that we received from the six Contributing FCMs in June 2013.

To analyze assets at risk as a result of under-segregation arising from misfeasance or malfeasance, the above data alone was sufficient. Under-segregation losses arising from fraud, embezzlement, unauthorized conversions of customer funds, and the like, after all, need not and historically have not occurred on days when markets themselves are experiencing catastrophic price volatility. Fellow-customer losses, by contrast, are more likely to occur in highly stressed market conditions that cause market prices to exceed the price movements used to compute initial margin requirements.

So, to analyze and quantify potential fellow-customer losses, we worked with the Clearing division of CME to perform stressed simulations of potential fellow-customer losses using a model similar to the one used by CME Clearing to measure its exposure to potential defaults by clearing FCMs. Specifically, we assumed that the prices of all futures contracts change by an amount that averages the worst 0.1% of all historical price changes dating back generally to 1987.[15] To be conservative in our analysis, we assumed that all products within each commodity type experienced losses at the same time, and then ranked the losses of all customers at each Contributing FCM and calculated the "hole" in customer funds that resulted from a failure to meet a margin call by all customers from the 98th largest net margin payment obligation up to the 99.5th largest net margin payment obligation. Finally, we assumed that defaulting FCMs contributed none of their own financial resources to cover the unmet customer payment obligations, another conservative assumption.[16] We completed our stressed analyses of potential fellow-customer losses in late August 2013. The completed Study will summarize and present all of the

[13] *See* J. Roe, "Commodity Insurance Corporation: A Proposal for a Captive Insurance Company Servicing Customers of Introducing Brokers, Commodity Trading Advisors and Commodity Pools," *Presentation of the CCC* (December 17, 2012) *http://commoditycustomercoalition.org/ccc-plan-for-private-commodity-customer-insurance/* (last visited September 25, 2013).

[14] We limited our request to 2012 both because recent regulatory changes make earlier time periods less representative of the market, going forward, and because of the demanding nature of our data request on the voluntary FCM contributors.

[15] For more recently listed products, we used data back to the inception of the products or the first date on which the data was clean. For some older products (*e.g.,* gold and some interest rate products), we use historical data back to the early 1980s.

[16] We adopted the assumption that FCMs contribute nothing to cover losses arising from customer defaults purely for conservatism and not because it is realistic.

relevant loss estimates that were computed for under-segregation and fellow-customer risk.

We then provided various loss exposure analyses to ten potential CAPI (re-)insurers. We also have participated in various meetings and calls with the potential CAPI (re-)insurers since providing our loss exposure analyses. Most of the (re-)insurers have expressed interest exclusively in the industry RRG scenario and have not indicated any intention to provide us with indicative pricing for the first (CAPI provided directly to customers) or second (CAPI provided to individual FCMs) scenarios. As of today, we are waiting for indicative premium quotations from the interested (re-)insurers regarding the cost of providing CAPI coverage. When we have that information, we will provide the completed Study to this Committee.

Mandatory CAPI Coverage

The fourth scenario we analyzed involves the mandatory and universal CAPI coverage of U.S. futures customers. Specifically, the Futures Investor and Customer Protection Act would establish the Futures Investor and Customer Protection Corporation ("FICPC").[17] The proposed customer asset protection scheme would be mandatory, universal, and would essentially mimic the protections afforded to securities investors by the Securities Investor Protection Corporation ("SIPC"). Unlike the scenarios described previously, the FICPC scenario would not give FCMs or customers a choice regarding their participation in the CAPI scheme—all FCMs and their customers would be required to participate.

A FICPC designed along the lines of SIPC would provide up to $250,000 to all FCM customers as reimbursement for losses sustained from the failure of an FCM (apart from losses arising purely as the result of financial market downturns). Following an FCM's insolvency, its customers would file claims with a FICPC trustee (analogous to a SIPC trustee). The trustee would have the authority to transfer customer accounts to non-defaulting FCMs or to liquidate those accounts.

Under this proposal, the FICPC would be funded by mandatory payments from FCMs of up to 0.5 percent of each FCM's previous annual gross revenues related to futures trading until reaching a target funding level of not more than $2.5 billion. FICPC would be governed by a board of directors to be confirmed by a majority vote of the U.S. Senate. In the FICPC, there is no retained first-loss layer by either customers or any other market participants.

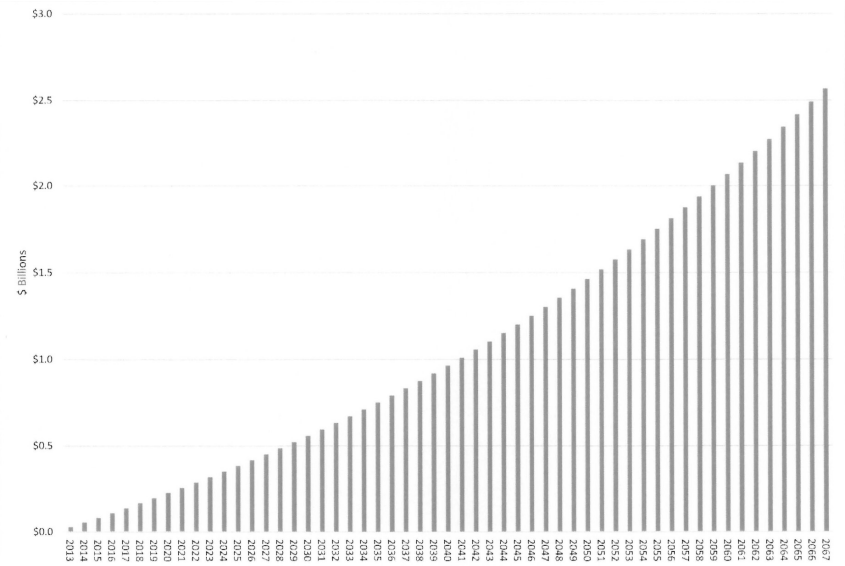
Several potential concerns can be identified in the FICPC scenario. In particular, the proposed funding scheme for the FICPC is highly regressive—*i.e.,* FCMs whose customers benefit the least from FICPC coverage would provide a disproportionately high amount of the funding. In 2012, a total of 70 FCMs reported positive annual gross revenues from commodities to CME and NFA in their capacities as DSROs. The ten FCMs with the highest amounts of customer assets at year-end 2012 would have accounted for 44 percent of the FICPC funding. Yet, the median value of customer assets on deposit at Large FCMs in 2012 (based on data from the Contributing FCMs) was roughly $1.4 million, as compared to median customer assets on deposit at Small and Medium FCMs in 2012 of $4,434 and $5,089, respectively.

In addition to the regressive nature of the proposed funding scheme, another concern with FICPC is the total amount of funding that the proposed plan would generate over time. In 2012, the 70 FCMs reporting positive annual gross revenues from commodities to CME and NFA had average annual gross revenues of $72.9 million, and the total annual gross revenue for all FCMs was $5.1 billion. In the first year, FICPC would receive (based on 2012 gross revenue numbers) an average of $364,591 from each FCM for a total across all FCMs of $25,521,370.

If no losses and CAPI claims occur in the first year of the FICPC, its assets would grow over time. Yet, the growth rate of FICPC's assets would be incredibly slow *vis-à-vis* the target funding level of $2.5 billion. For example, assuming a two percent return on FICPC's assets each year and an annual contribution by FCMs of $25,521,389 (*i.e.,* assuming gross revenues for futures remains at 2012 levels), the FICPC would not reach its target $2.5 billion funding level for 55 years. *Figure 1* below shows the assets of a FICPC Fund under those assumptions and further assuming that the first $25.5 million was paid in during 2013 based on 2012 gross revenue numbers *and that no claims payments are made.* The FICPC Fund would cross the $1 billion asset threshold in 2041 (*i.e.,* 27 years after its inception).

[17] Statement of CFTC Commissioner Bart Chilton (August 9, 2012).

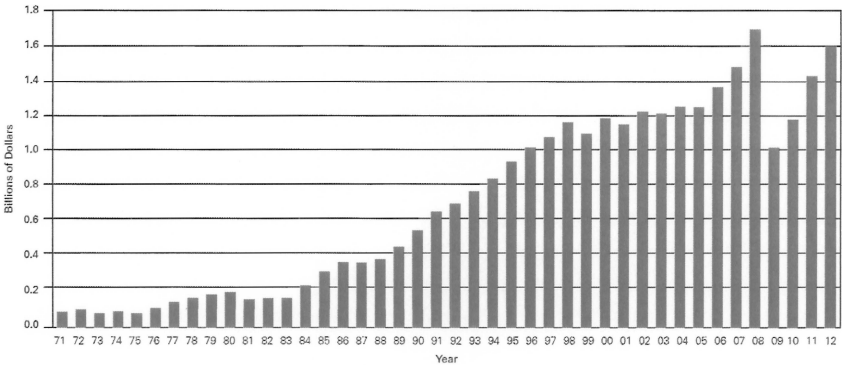
Figure 1: FICPC Fund Projected Asset Levels



Notes: Assumes constant annual contributions to FICPC of $25,521,389 (*i.e.,* 0.5% of 2012 gross revenues from commodities for all FCMs that reported positive gross revenues in 2012) and that FICPC assets are invested in government bonds earning 2% per annum.

The SIPC Fund faced the same problem when it was created by Congress in 1970. *Figure 2* below shows that the Fund grew sluggishly over time and did not exceed $1 billion until 1996 (*i.e.,* 25 years after its inception). SIPC, however, is an entity in which the U.S. Government is the equivalent of a reinsurer of up to $2.5 billion. Specifically, if the SIPC Fund is or appears to be insufficient to cover claims, the Securities and Exchange Commission can make loans to SIPC (backed by notes issued to the U.S. Treasury) in an aggregate amount not to exceed $2.5 billion.

Figure 2: SIPC Fund from Inception to December 31, 2012



Source: Securities Investor Protection Corporation, *2012 Annual Report,* p. 29.

So, FICPC might not provide much short-term comfort to futures customers given the slow growth rate in the assets available to cover any eligible customer claims. Without a government backstop (and the corresponding taxpayer-financed contingent liability), the program would be significantly under-funded both in absolute

terms and relative to the potential voluntary, private market-based solutions that we have identified.

Because of its mandatory and universal nature, moreover, FICPC likely would result in new costs for U.S. futures trading participants. Those additional costs could deter customers from using futures markets to satisfy their risk-management needs and depress market liquidity, thereby potentially further raising costs for customers.

Conclusion

For nearly a year, we have been researching and studying the potential benefits and costs of alternative CAPI programs. Our discussions to date with various (re-)insurers suggest a willingness and ability to provide capital to underwrite a private, voluntary CAPI program along the lines of an industry RRG in which FCMs bear the first-loss exposure to losses arising from FCM under-segregation or fellow-customer risk. In other words, the supply seems to be available to cover these risks, but we remain uncertain at this date as to the cost of that risk capital and the resulting demand for privately provided CAPI given those as-yet-unknown costs. Yet, if there is sufficient demand for CAPI amongst FCMs and customers at the price that the reinsurance market charges and a willingness of FCMs to contribute their own capital to cover the first-loss layer, then those willing FCMs and customers could have access to customer funds protection through a non-mandated, market-based solution.

If it turns out, however, that there is limited demand for private CAPI solutions at the market price, then a mandated CAPI solution may be even more unrealistic. In other words, to the extent that a subset of market participants are unwilling to pay for voluntary CAPI, it is very likely that requiring *all* market participants to purchase CAPI at the mandated expense of the industry will be undesirable. A mandated CAPI solution, moreover, would likely be feasible only with either implicit or explicit taxpayer-backed government support. In addition, the added transaction costs that such a solution could ultimately impose on customers might simply cause some customers to stop relying on U.S. futures markets for their risk-management needs, which could reduce market liquidity and give rise to even higher transaction costs for remaining market participants.

The CHAIRMAN. Thank you, Dr. Culp.

Mr. Anderson.

STATEMENT OF MICHAEL J. ANDERSON, REGIONAL SALES MANAGER, THE ANDERSONS INC., UNION CITY, TN; ON BEHALF OF NATIONAL GRAIN AND FEED ASSOCIATION

Mr. ANDERSON. Thank you. Good morning, Chairman Conaway, Ranking Member Scott, and Members of the Subcommittee.

I work at The Andersons, Incorporated. I live in northwest Tennessee and run a series of elevators there. The Andersons is a diversified company rooted in agriculture. We were founded in Maumee, Ohio, in 1947, and we conduct business across North America in grain, ethanol, plan nutrient sectors, railcar leasing, turf and cob products, and consumer retailing. Today, I am here representing the National Grain and Feed Association. I serve on the NGFA's risk management committee, and I am NGFA's representative to the CFTC Ag Advisory Committee.

In my written testimony, I have detailed several areas that we believe are important for Congress to consider during the CFTC reauthorization. I am going to focus today on the rule proposed by CFTC last November that would radically change the way business is done in the futures industry. We believe strongly that despite CFTC's goal of enhancing customer protections, that these two provisions of the rule will actually cause a dramatic increase in customer risk.

The first provision would decrease the time in which customer margin calls must arrive to their futures commission merchant, or FCM, from the current 3 days to just 1. Otherwise, the FCM would

have to take a capital charge for this undermargined account. Even in today's environment, of money moving electronically, 1 day is not sufficient for all customers to make their margin calls. We are urging CFTC to maintain the current 3 day timeline; otherwise, we fear some FCMs would require customers to pre-margin these hedge accounts, potentially putting more customers' funds at risk in another FCM insolvency.

The second provision of concern, and maybe more troubling than the first, would change the timing of the FCM's calculation of residual interest, which are the funds the FCM contributes of its own money to top up customer accounts until margin calls are received. For decades, this provision of the Commodity Exchange Act has been interpreted by the Commission as allowing some period of time for the FCMs to do this. The CFTC proposal would change that consistent historical interpretation to require that every customer be fully margined on a 24/7 basis. It may sound like a good idea, but in the real world, it causes major problems. Future Industry Association has estimated this provision alone would cost as much as $100 billion per day to be contributed to hedge accounts either by FCMs or by futures customers. This would severely stress FCM's liquidity, especially the smaller and mid-sized FCMs that we rely on to serve the ag industry, again, leading us to believe that pre-margining would be a likely conclusion.

An unintended consequence could be further consolidation in the FCM world as smaller firms cannot compete with larger firms who are able to top up these hedge accounts. To bring this down to the everyday world, I am going to repeat an example that has been given before, so apologies if you have heard it.

Consider an average Midwestern grain elevator that handles 5 million bushels of grain every year. Before harvest, this elevator may have 40 percent of its annual grain volume purchased from its farmer customers through forward contracts, and assuming a crop mix of 60 percent corn, 30 percent soybeans and ten percent wheat, that elevator would have to hedge 300 contracts of grain. Today, that would result in a minimum of $920,000 that that country elevator has to send to the FCM just to establish its hedged positions, and recall, this is just one country elevator.

Now, if we look at the additional financial requirements, if the CFTC proposal was put into effect, we will assume that the elevator's FCM is going to require pre-margining of the customer to cover a 1 day limit move, which is a reasonable precaution, that country elevator would then have to send an additional $1 million more to the FCM for the possibility of this limit move that may or may not occur. If MF Global had been requiring pre-margining of this fashion, that country elevator is now exposed more than two times what it would have been originally, about $1.9 million as opposed to the original $900,000 it had to send to established positions.

Further, we continue to be confused as to why the meaning of the Commodity Exchange Act has been changed after decades of consistent interpretation. We believe that the Act provides plenty of flexibility for the CFTC's historical interpretation, and we would be happy to discuss that in more detail. We are also mystified as to why the CFTC apparently has not undertaken serious cost-ben-

efit analysis before implementing such a major change in the way the futures industry does business. An indication of the serious problems this proposal would cause for U.S. agriculture, 21 national organizations signed a letter to the Commission on September 18th detailing consequences and urging serious analysis by the CFTC before moving forward on these two provisions.

And Mr. Chairman, I request that this letter be included in the hearing record, if that is all right.*

The CHAIRMAN. Without objection.

Mr. ANDERSON. We would prefer to work with CFTC to resolve these problems, but there may be a need for legislative action to clarify the interpretation that the futures industry has relied on for so long. I thank you sincerely for taking the time to hear from our industry today, and I would be happy to respond to any questions.

[The prepared statement of Mr. Anderson follows:]

PREPARED STATEMENT OF MICHAEL J. ANDERSON, REGIONAL SALES MANAGER, THE ANDERSONS INC., UNION CITY, TN; ON BEHALF OF NATIONAL GRAIN AND FEED ASSOCIATION

Good morning, Chairman Conaway, Ranking Member Scott, and Members of the Subcommittee. I am M.J. Anderson, Regional Sales Manager of The Andersons Inc. in Union City, Tennessee. The Andersons Inc. is a diversified company rooted in agriculture. Founded in Maumee, Ohio, in 1947, the company conducts business across North America in the grain, ethanol and plan nutrient sectors, railcar leasing, turf and cob products, and consumer retailing.

Today, I am testifying on behalf of the National Grain and Feed Association (NGFA), the national trade association representing more than 1,000 companies including grain elevators, feed manufacturers, processors and other commercial businesses that utilize exchange-traded futures contracts to hedge their risk and assist producers in their marketing and risk management strategies. We appreciate the opportunity to testify before the Subcommittee today.

CFTC's Customer Protection Proposal—Customer Protection and Customer Risk

For many years, grain hedgers and the futures commission merchants (FCMs) with whom they work to manage their risk have relied on a consistent interpretation of the Commodity Exchange Act by the Commodity Futures Trading Commission (CFTC) with regard to posting margin funds to their hedge accounts. Unfortunately, in the name of customer protection, that interpretation recently has been thrown into question by a new proposal from the CFTC that we believe would dramatically *increase* customer risk.

We understand that CFTC Commissioners currently are evaluating a final staff draft of this rule, with the goal of voting on a final rule later this month. The rule seeks to bolster futures customer protections—a laudable goal that the NGFA supports fully. However, two very troublesome provisions would have the perverse effect of significantly increasing financial risk to futures customers—and in the process, dramatically changing the way business has been conducted in futures markets for decades.

One provision concerns the timing of when an FCM is required to take a capital charge for undermargined accounts. Currently, customers have 3 days to make margin calls to their FCMs before the FCM is required to take a capital charge. As we read the CFTC proposal, that 3 day period would be shortened to just 1 day. Even in today's environment of money moving electronically, a single day is not sufficient for all customers to make margin calls that quickly. We fear this provision would compel FCMs to require that customers pre-margin their accounts—especially the smaller and mid-size FCMs that are so important in providing service to futures customers in the agribusiness and production agriculture spaces.

The second provision potentially is even more troublesome and more expensive to futures customers. It would change the timing of FCMs' calculation of residual interest for futures accounts—in other words, it appears the proposal would require

*The document referred to follows Mr. Anderson's prepared statement and is entitled *Attachment*.

all customers to be fully margined at all times. While this may sound like common sense, it is a huge departure from the CFTC's interpretation for decades that FCMs be allowed a certain period of time to "top up" hedge accounts while they wait for customers to make margin calls. This new proposal would lead to one of two outcomes: either the FCM would have to move more of its own funds (*i.e.,* residual interest) into customers' hedge accounts; or FCMs would be forced to require pre-margining and, perhaps, intra-day margining, to ensure that each individual customer is fully margined at any moment.

The practical end result would be that futures customers would be required to send much more money to their FCMs in advance in anticipation of futures market moves that might never happen. Some customers likely would exit futures markets in favor of lower-cost risk management alternatives. We believe this potential exodus from futures markets would be most clearly seen among agricultural producers who utilize futures for risk management purposes and among smaller grain-hedging firms.

Taken to its logical conclusion, we believe strongly that neither proposal accomplishes the Commission's stated goal of enhancing customer protection. To the contrary, customers would be sending much larger amounts to their FCMs, leading to much greater volume of funds at risk if another MF Global situation occurs. ***If this rule had been in place when MF Global failed, perhaps twice as much customer money would have been missing and a correspondingly larger amount still would not be returned to customers.***

Much has been said about the meaning of the Commodity Exchange Act with regard to residual interest. Some at the CFTC have seized on a single sentence of the act in Section 4d(a)(2) to contend that the CEA prohibits one customer's funds from being used to cover another customer's margin calls. We believe strongly that the Commission's recent public stance is an overly aggressive interpretation that overturns decades of consistent administration of the regulations by the Commission, Congress and the futures industry. As a recent legal review by the Futures Industry Association has shown, there is ample flexibility in the Act to justify the manner in which residual interest rules historically have been implemented. Specifically, we believe the first of three "*Provided, however,*" clauses immediately following the limits in Section 4d(a)(2) give clear authority for the historical interpretation.

Perhaps most troubling about this entire issue is that, to our knowledge, the Commission has performed no credible cost-benefit analysis relative to these specific provisions of the proposal. We believe strongly that this fundamental change of direction by the Commission—after decades of consistent interpretation—deserves a serious effort to quantify benefits relative to the enormous costs and risks imposed on futures customers. We respectfully urge the Commission to undertake a serious and thorough review prior to any action on the capital charge and residual interest provisions of the referenced rulemaking.

On that note, we would like to thank you, Chairman Conaway and Ranking Member Scott and others, for sponsoring H.R. 1003, legislation that would require the Commission to perform both qualitative and quantitative cost-benefit analysis of potential regulations before issuing them. Such analysis likely would have provided the Commission with important and helpful information prior to publication of the customer protection rule. The NGFA supports inclusion of H.R. 1003 in legislation reauthorizing the CFTC.

Discussions with the Commission have not resolved these issues to date, and we continue to be mystified about how the meaning of the Commodity Exchange Act, interpreted consistently on this matter for decades, suddenly has changed. It is difficult to understand the reason for such a dramatic change in the CFTC's stance after decades of consistent interpretation. We continue to believe that the Act provides sufficient flexibility. However, if the Commission continues to contend that its hands are tied due to provisions of the Commodity Exchange Act, Congressional action may be needed to clarify the matter.

Widespread Concern in U.S. Agriculture and Agribusiness

The proposed changes in capital charge and residual interest provisions have provoked very deep concerns among a broad swath of U.S. farmers, ranchers and agribusiness firms who utilize futures markets to manage risk in their businesses. On September 18, twenty-one national organizations wrote to CFTC Commissioners warning of the following consequences if these provisions are finalized:

- "FCMs will be forced either to use their own funds to 'top up' residual interest—not feasible given the huge amounts involved—or, most likely, require that customers pre-margin hedge accounts.

- Many producers who use futures directly will be discouraged from using futures markets to hedge their production risk.
- Due to the significantly increased funding requirements of pre-margining—perhaps nearly double the amounts currently required—many small agribusiness hedgers will be forced to consider alternative risk management tools or be forced out of the market.
- Futures customers will be compelled to send excess margin to their FCMs *in anticipation* of future market movement on existing positions—many billions of dollars more than needed to cover existing positions—the last thing customers want to do now, in the wake of MF Global and Peregrine Financial Group.
- Much more customer money—maybe twice as much—will be at risk in the event of another FCM insolvency.
- Futures customers will be compelled to borrow more money just to post margin on *potential* market moves—difficult for both lending banks and for customers to predict, and potentially difficult for smaller local banks. This increased borrowing requirement negatively affects a customer's ability to invest in their own business.
- The entire hedging process will be made less cost-efficient, thereby discouraging use of futures markets."

It is very important to note again that these organizations are not investors or speculators. They represent farmers, ranchers and the agribusinesses that work with production agriculture to hedge their business risk. We believe it should be of deep concern to the Commission that many of the affected individuals and firms may be forced by the huge added expense of using futures to find other, less-costly forms of risk management—and that the smaller and mid-sized FCMs that provide such important service to U.S. agriculture stand to be disproportionately disadvantaged. It is in no one's interest to cause consolidation among FCMs, thereby concentrating risk in a smaller number of firms.

Reforms to the U.S. Bankruptcy Code

Nearly 2 years after the implosion of MF Global, companies and individuals that were customers of that FCM continue to deal with the aftermath of parent company MF Global Holdings' bankruptcy and misuse of futures customer funds. Most U.S. futures customers so far have received distributions from the trustee of about 97% of their funds—funds that were supposed to have been segregated and protected. Recent developments have made it increasingly likely that 100% of customer funds will be returned to customers, but the NGFA believes strongly that statutory reforms are needed with the twin goals of preventing similar occurrences in the future and enhancing the rights and protections of futures customers in the event of a future FCM insolvency.

Among those changes, we believe that reforming the U.S. bankruptcy is the single most important step essential to preserving and codifying customers' rights and protecting customers' assets. To that end, the NGFA recommends the following statutory changes:

- The Bankruptcy Code should state clearly that customers always are first in line for distribution of funds, ahead of creditors, and that all proprietary assets including those of affiliates must go to customers first. This would provide clarity to regulators and to the courts in terms of prioritization of claims, an area in which precedent has not been established.
- Part 190 regulations of the CFTC should be incorporated into Subchapter IV of Chapter 7 of the Bankruptcy Code to harmonize the statutes and remove any interpretative inconsistencies. Generally, the Bankruptcy Code provides a limited description of the liquidation process of a commodity futures broker. The Commodity Exchange Act and bankruptcy regulations drafted by the CFTC provide much greater and more detailed guidance for the liquidation of a commodity broker or FCM.
- Under current bankruptcy law, powers of a trustee to recover customer funds are limited under so-called "safe harbor" provisions unless actual intent to defraud customers/creditors can be shown. The NGFA strongly recommends that any transaction involving the misappropriation of an FCM's customer property should not be protected under safe harbor provisions, regardless of the intent behind a fund transfer.
- To strengthen commodity customer protection, the CFTC should have a specifically identifiable role in the liquidation of an FCM. The CFTC should have the authority to appoint its own trustee to represent exclusively the interests of

commodities customers. In a case like MF Global, in which over 95% of the assets and accounts affected were those of commodities customers, we believe the CFTC's authority should be strengthened and clarified.

- In the MF Global situation, creditor committees were established under the MF Global Holdings Chapter 7 proceeding, but there was no statutory provision under the SIPA liquidation of the MF Global Inc. for establishment of customer committees. The NGFA recommends that the Bankruptcy Code expressly should authorize the establishment of customer committees to represent FCM customer interests.

We are aware that other organizations also are working toward specific recommendations for changes in the Bankruptcy Code that will enhance customer protections. The NGFA intends to work cooperatively with such groups to develop consensus reforms that can be moved by Congress expeditiously.

Insurance or Liquidity Protection for Commodity Futures Customers—The NGFA recommends that insurance or insurance-like products should be available to commodity futures customers. Customers and their lenders who finance hedging in commodity markets must have confidence that their funds are safe and protected. We are aware that the Futures Industry Association and others currently are finalizing a comprehensive analysis of potential products and costs, and we consider it prudent to see that study before recommending a particular structure. We also are aware that the Commodity Customer Coalition recently has completed an online survey of commodity futures customers to gauge interest and input on insurance products. This data also could prove useful in crafting appropriate solutions.

Since the NGFA began working on potential customer protection enhancements early last year, we have been very mindful that most new customer protections will come at a cost—and that, eventually, the cost most likely will be borne by the customer. For that reason, we have taken a deliberate approach to recommending specific new protections, and we respectfully suggest that Congress and all stakeholders adopt a similarly cautious view. On the bright side, since the collapse of MF Global, significant new operational safeguards that should enhance the safety of customer funds have been put in place on commodity futures accounts by exchanges and regulators. These enhancements, already in place, should help mitigate costs of insurance or other customer protection efforts.

It is important to note that the solution on insurance to protect customers is not necessarily a government solution or a legislated solution. It may be that some form of privately provided product is more cost-effective and more appropriate. The NGFA has taken no formal view at this point on any specific structure. We advise strongly that data from the above-referenced efforts should be carefully considered prior to making such an important decision.

Fully Segregated Customer Accounts/Pilot Program—Currently, the Commodity Exchange Act and U.S. Bankruptcy Code provide for *pro rata* distribution of all customer property that was held by a failed futures commission merchant (FCM). Almost 2 years after the fact, former customers of MF Global still have not received back 100% of their supposedly safe segregated funds. This is unacceptable. Restoring the confidence not only of customers, but also of their lenders, is critically important. To that end, the NGFA has recommended establishment of an *optional* fully-segregated account structure to be offered and utilized by mutual agreement of customers and their FCMs.

Creation of a fully-segregated account structure necessarily would result in some additional costs that likely would be borne by customers that utilize such accounts. It is likely that some customers would opt for the added protections despite extra costs, while other customers might be unwilling or unable to bear those extra costs. For that reason, we propose that the full-segregation option be utilized on a voluntary basis at the agreement of an FCM and its individual customers.

We suggest that a pilot program involving a limited number of commodity futures customers, FCMs, and lenders, along with regulators, would be a useful means of testing the mechanics and identifying the viability and true costs of a full-segregation structure. It is our understanding that similar structures already are in place in the swaps marketplace, and perhaps that can offer insights into similar accounts for futures customers who may desire the same kind of protection. The NGFA does *not* recommend legislative action to establish a full-segregation account structure, but support for a pilot to test concepts would be constructive.

High Frequency Trading

Increasingly, traditional customers of agricultural futures markets are concerned about the impacts of high-frequency trading. Especially immediately preceding and following release of important crop and stocks reports by the U.S. Department of

Agriculture, we believe high-frequency trading has caused and magnified volatile market swings. These disruptions have led many hedgers to avoid futures markets at such times, leading the NGFA to recommend a short pause in trading around releases of key USDA reports. Concerns also have been raised about the impact of high-frequency trading on order fills for traditional hedgers and about timely access to USDA reports, especially for those without mega-high speed connections.

It may be that regulatory action by the CFTC is the more appropriate way to address high-frequency trading issues. Should high-frequency traders be required to register with the Commission? Should such traders be required to post margin even if no positions are held at day's end? Are there other measures that should be considered to help ensure that high-frequency trading does not disrupt futures markets in ways that render them less useful to hedgers managing business risk? The NGFA suggests that these kinds of questions should be part of the conversation during reauthorization.

We look forward to working with the Committee on these and other matters during the reauthorization process. Please do not hesitate to contact the NGFA with any questions.

ATTACHMENT

September 18, 2013

Hon. GARY GENSLER,
Chairman,
Commodity Futures Trading Commission,
Washington, D.C.

RE: RIN 3038–AD88: *Enhancing Protections Afforded Customers and Customer Funds Held by Futures Commission Merchants and Derivatives Clearing Organizations,* 77 FED. REG. 67866 (November 14, 2012)

Dear Chairman Gensler:

The undersigned organizations represent a very broad swath of agricultural futures market participants, including crop and livestock producers who use futures directly to manage their risk; agribusiness firms who rely on futures markets as they assist producers with risk management plans and in their own risk management programs; as well as lenders that support the industry's risk management activities.

We support strongly the Commission's efforts to enhance futures customer protections. However, the capital charge and residual interest provisions of this rule will have the opposite impact—if adopted, customers will be exposed to significantly greater financial risk.

If adopted as proposed, these provisions likely will have the following impacts:

- FCMs will be forced either to use their own funds to "top up" residual interest—not feasible given the huge amounts involved—or, most likely, require that customers pre-margin hedge accounts.
- Many producers who use futures directly will be discouraged from using futures markets to hedge their production risk.
- Due to the significantly increased funding requirements of pre-margining—perhaps nearly double the amounts currently required—many small agribusiness hedgers will be forced to consider alternative risk management tools or be forced out of the market.
- Futures customers will be compelled to send excess margin to their FCMs *in anticipation* of future market movement on existing positions—many billions of dollars more than needed to cover existing positions—the last thing customers want to do now, in the wake of MF Global and Peregrine Financial Group.
- Much more customer money—maybe twice as much—will be at risk in the event of another FCM insolvency.
- Futures customers will be compelled to borrow more money just to post margin on *potential* market moves—difficult for both lending banks and for customers to predict, and potentially difficult for smaller local banks. This increased borrowing requirement negatively affects a customer's ability to invest in their own business.
- The entire hedging process will be made less cost-efficient, thereby discouraging use of futures markets.

Much has been said about the meaning of the Commodity Exchange Act, particularly with regard to the timing of residual interest calculations and FCMs' receipt

of customers' margin. With respect, we believe strongly that the Commission's recent public stance is an overly aggressive interpretation that overturns decades of consistent administration of the regulations by the Commission, Congress and the futures industry. As a recent legal review by the Futures Industry Association has shown, there is ample flexibility in the Act to justify the manner in which both capital charge and residual interest rules historically have been implemented.

Clearly, the proposed rules are a huge change to the way the futures industry does business. However, by its own admission, the Commission has performed no credible cost-benefit analysis relative to these specific provisions of the proposal. We believe strongly that this fundamental change of direction by the Commission—after decades of consistent interpretation—deserves a serious effort to quantify benefits relative to the enormous costs and risks imposed on futures customers. We respectfully urge the Commission to undertake a serious and thorough review prior to any action on the capital charge and residual interest provisions of the referenced rulemaking.

Sincerely,

AMCOT
American Cotton Shippers Association
American Farm Bureau Federation
American Feed Industry Association
American Soybean Association
CoBank
Commodity Markets Council
National Association of Wheat Growers
National Barley Growers Association
National Cattlemen's Beef Association
National Corn Growers Association
National Cotton Council
National Council of Farmer Cooperatives
National Grain and Feed Association
National Pork Producers Council
National Sorghum Producers
National Sunflower Association
North American Millers Association
USA Rice Federation
U.S. Canola Association
U.S. Dry Bean Council

CC:

Hon. BART CHILTON,
Hon. SCOTT O'MALIA,
Hon. MARK WETJEN,
Members of Senate and House Agriculture Committees.

The CHAIRMAN. Thank you, Mr. Anderson.

Mr. Koutoulas.

STATEMENT OF JAMES L. KOUTOULAS, ESQ., PRESIDENT AND CO-FOUNDER, COMMODITY CUSTOMER COALITION, INC., CHICAGO, IL

Mr. KOUTOULAS. Chairman Conaway, Ranking Member Scott, Members of the Committee, thank you for the opportunity to testify at this important hearing. My name is James Koutoulas, and I am the President and Co-Founder of the Commodity Customer Coalition. While I also serve on the board of directors of the National Futures Association, my testimony does not necessarily represent the views of that organization. While I am deeply honored that our organization was invited to testify before this Committee before the 2 year anniversary of our creation, the fact that we exist at all is evident of the need to improve protections for commodity customers.

For those unfamiliar with us, a lot of things had to go wrong for the CCC to be formed. With MF Global teetering on the bank-

ruptcy, it's DSRO, CME Group had grave concerns about the sanctity of segregated accounts and, 4 days before FCM's global bankruptcy, instructed its management that no transfers were permitted without CME's express written consent. However, CME Group did not take the extra step of enforcing that instruction by requiring CME approval for wire transfers initiated from MF Global's customer accounts, and it did not require CME's approval in JP Morgan assets, its treasury software. That would have only taken a few minutes to configure. This oversight allowed MF Global staff to transfer customer funds to meet house margin calls at JP Morgan, creating a shortfall of over $1 billion, according to the MF Global, Inc., trustee's report.

This occurred despite the fact that, per the trustee's report, JP Morgan's chief risk officer personally informed MF Global senior management that JP Morgan thought customer funds were at risk. JP Morgan sent MF Global management three variants of a comfort letter asking them to certify that no customer funds were transferred. And although none of these letters were signed and returned by MF Global management, JP Morgan did not return those customer assets for over 18 months after the bankruptcy.

Once MF Global filed for bankruptcy, its counsel represented there was no shortfall in customer accounts, despite internal communication otherwise. On that basis, the bankruptcy judge permitted MF Global holdings to enter Chapter 11 rather than Chapter 7 and appointed another trustee to oversee that reorganization. The appointed trustee permitted MF Global senior management to remain at the firm, even though well over a billion dollars of customer money was still unaccounted for and even went so far as to claim attorney/client privilege on their behalf in his dealings with criminal investigators. This transpired in conjunction with the SIPA trustee's alarming initial plan to keep MF Global customers' cash frozen for a full 9 months after the bankruptcy and only then allow the release of 60 percent of the funds.

In the face of this long list of obstacles delaying the return of their property, thousands of customers reached out to John Roe and myself and asked us to help them. We had farmers saying we are incapable of buying seed. Retirees couldn't withdraw their savings to buy medicine. We had a single mom who said she was in danger of losing her home, because of this we spent thousands of hours doing *pro bono* service to help recover this property.

Now here we stand where the CFTC is asking customers to double down on this FCM system that they don't trust after MF Global, they really don't trust after PFG, and comply with this new residual interest rule. And this rule will definitely do more harm than good. We understand where the CFTC is coming from, wishing to protect customers from fellow-customer risk, which is a very valid concern, but asking that the hedge accounts, the farmers and ranchers, to go to $900,000 up to $2 million and expose that to FCM malfeasance when the regulators have proven that they can't stop this, I think that is ridiculous.

And I think that what the CFTC could do is to go and maybe enforce this residual interest rule on high frequency traders, on firms which, in a couple of minutes, with a rogue algorithm can

blow up an FCM, but they shouldn't impose it on general commodity customers and upon hedge customers.

And moving on to insurance. In testimony before the Senate Committee on Agriculture, Nutrition, and Forestry, the CCC advocated for the creation of a private insurance mechanism to cover FCM malfeasance, much like the one Dr. Culp delineated. We were the only group to advocate for such a plan before the PFG failure, and we still believe it is a good idea. We agree with Dr. Culp that private opt-in insurance is the only feasible method for implementation of that, and we urge your Committee to consider that.

And again, thank you, Chairman Conaway, Ranking Member Scott, for having us here today. We are deeply honored and hope that our feedback is helpful.

[The prepared statement of Mr. Koutoulas follows:]

PREPARED STATEMENT OF JAMES L. KOUTOULAS, ESQ., PRESIDENT AND CO-FOUNDER, COMMODITY CUSTOMER COALITION, INC., CHICAGO, IL

Chairman Conaway, Ranking Member Scott, Members of the Committee, thank you for the opportunity to testify at this important hearing. My name is James Koutoulas and I am the President and Co-Founder of the Commodity Customer Coalition. While I also serve on the Board of Directors of the National Futures Association, my testimony does not necessarily represent the views of that organization.

While I am deeply honored that our organization was invited to testify before this Committee before the 2 year anniversary of our creation, the fact that we exist at all is evident of the need to improve protections for commodity customers. For those unfamiliar with us, a lot of things had to go wrong for the CCC to be formed.

Industry Failures Results in the Formation of the CCC

With MF Global teetering on the brink of bankruptcy, its DSRO, CME Group, had grave concerns about the sanctity of segregated accounts and, 4 days before the bankruptcy, instructed MF Global management that no transfers were permitted without CME's express written consent. However, CME Group did not take the extra step of enforcing that instruction by requiring CME approval for wire transfers initiated via MF Global's treasury software, JP Morgan Access, something that would have only taken a few minutes to configure. This oversight allowed MF Global staff to transfer customer funds to meet house margin calls at JP Morgan, creating a shortfall of over $1 billion according to the MFGI trustee's *MF Global Investigation Report.* This occurred despite the fact that, per the trustee's report, JP Morgan's Chief Risk Officer personally informed MF Global management that they thought customer funds were at risk. JP Morgan sent MF Global management three variants of a comfort letter asking them to certify that no customer funds were transferred, and, although none of the three letters were signed and returned by MF Global management, JP Morgan did not return these customer assets for over 18 months after the bankruptcy.

Once MF Global filed for bankruptcy, its counsel represented that there was no shortfall in customer accounts, despite internal communication by MF Global senior management to the contrary. On that basis, the bankruptcy judge permitted MF Global Holdings to enter Chapter 11 rather than Chapter 7, and appointed an additional trustee to oversee that "reorganization." The appointed trustee permitted MF Global senior management to remain at the firm, even while over a billion dollars in customer money was still unaccounted for, and even went so far to claim attorney-client privilege on their behalf in his dealings with criminal investigators. This transpired in conjunction with the SIPA trustee's alarming initial plan to keep MF Global customers' cash frozen for a full 9 months, and then allow the release of only 60% of the funds.

In the face of this long list of obstacles delaying the return of their property, thousands of customers reached out to John Roe and myself after we received early media attention for our efforts to expedite the return of our own customers' property. After hearing stories of farmers incapable of buying seed, retirees unable to withdraw their savings to buy medicine, and a single mother who was in danger of losing her home, John and I organized the CCC and each contributed thousands of hours of *pro bono* service to help expedite the return of the property throughout the estate.

Outcomes for MF Global Customers

Thankfully, our advocacy and litigation efforts, helped by the indemnity that CME provided to the trustee, all customers received 72% of their property back that was in 4(d) designated accounts 7½ months ahead of the trustee's initial plan—although 30.7 customers had no such luck and only received a majority of their funds back 20 months after the bankruptcy. Now, thanks to the CFTC's proposed settlement with MF Global, Inc., all customers are expected to receive 100% of their property back roughly 2 years after the bankruptcy. While this outcome exceeds almost all of the expectations formed upon the realization that there was a shortfall of over a billion dollars in customer accounts, it is simply unacceptable that customers were deprived of their property for even 1 day. Worse still, they felt they had little choice other than to rely on a handful of volunteers, with no bankruptcy or litigation experience, to represent them against the country's biggest bank and a former FBI director.

After MF Global's collapse, the industry has shown a renewed vigor towards protecting customer funds, and has implemented many thoughtful reforms, such as those delineated by Mr. Roth, namely: the "MF Global Rule," more stringent standards for FCM internal controls, and the daily electronic confirmation of segregated account balances. Nevertheless, in the less than 2 years since MF Global's bankruptcies, eight FCMs have already been fined for failing to comply with various segregation regulations, PFGBest's transgressions the most grave amongst them.

Industry Failures Continue

PFGBest's customers have fared far worse than MF Global customers. Despite entrusting their funds to segregated accounts held by a regulated entity that was audited annually by a SRO, last summer their customers were told that over $200 million of assets had been stolen over 20 years. At this time, their only hope to recover more than 50% of their property is for the CFTC to prevail in its litigation against US Bank, which allegedly allowed PFGBest to treat its segregated accounts as if they were commercial checking accounts.

Strengthening Protections through Bankruptcy Reform and Insurance

While both governmental and private regulators have generally done a good job protecting customers historically, everyone makes mistakes. Unfortunately, customers have bared almost all of the consequences of both debacles, as no regulator has lost their job, JP Morgan has not faced an enforcement action for knowingly receiving customer funds, and no member of MF Global management has been charged with a crime or been investigated for the many potential misrepresentations they may have made before this, and other Congressional Committees. Thus, sole responsibility for the safety of customer property currently relies on a combination of public and private entities, none of whom have skin in the game, to maintain segregation at all times, which they have repeatedly failed to do.

Despite declining to enforce many of the existing regulations we already have on the books, the CFTC has now proposed over 500 pages of new rules, some of which we think add real value to customer protections, such as the expanded testing of FCM internal controls, the implementation of improved risk management procedures, and the required filing of certified FCM annual reports. Unfortunately, these proposed new rules also contain the most onerous burden ever placed on customers: the new residual interest rules.

The Proposed Changes to Residual Interest Do More Than Good

These rules would require customers whose faith in the segregated account system has been badly shaken by the failures of MF Global and PFGBest to double down on it, by almost literally requiring twice the amount of cash that is currently held in segregation industry-wide. The would-be Russ Wassendorfs of the world do not need access to more cash from farmers, ranchers, and investors should they wish to engage in future malfeasance. Moreover, the businesses of small-to-midsize agricultural users and traders have been severely strained over the last several years due to the difficulties of making money in a persistent zero interest rate environment and the loss of customer confidence due to the MF Global and PFGBest insolvencies. Requiring the industry to comply with hundreds of pages of new rules while also tying up additional capital could very well be the final straw that puts many out of business.

Instead of implementing many of these new rules, especially the proposed residual interest change, the industry as a whole would be better protected by consistently enforcing the existing. With respect to criminal penalties, I would like to remind the Committee that any willful violation of the Commodity Exchange Act is a felony punishable by 10 years in prison. There are least a few cases where this law should

have been enforced, but as of now, justice has yet to be pursued. On the civil side, penalties have generally been assessed in relatively fixed amounts, giving the regulatory regime the worst of both worlds—devastating small firms while failing to provide a meaningful deterrent to large firms.

It is Time to Finally Fix *Griffin Trading* and Restore Customer Priority

That is not to say some additional rule changes are not necessary. A few pages of legislative language would go a long way towards preventing future commodity customers from waiting years to receive the return of their property should another FCM go bankrupt with a shortfall in customer funds. In 1999, a small FCM named Griffin Trading was in such a situation. In *Griffin,* customers wound up recovering all of their property after an eventual settlement. Before that happened, a District Court judge held that the CFTC overstepped its authority by regulating that customers had priority over assets needed to fill a shortfall in segregated accounts. While this ruling was vacated by the settlement, it has still been cited as precedent for denying customers the immediate return of their property. **The industry has been well aware of the weakening of customer protections caused by *Griffin* for 14 years. Nevertheless, it did not make an effort to address it as part of the 2005 revisions to the Bankruptcy Code, which would have mitigated much of the suffering of Sentinel, MF Global, and PFGBest customers, and reduced the massive fees charged to those respective estates by bankruptcy trustees.**

Restoring Customer Priority Through Subordination

It is time that we address this long-neglected issue and take this opportunity to modify the CEA to require FCMs to subordinate the claims of their affiliates and lending institutions to customer claims in the event of a shortfall in segregated accounts. This would allow future bankruptcy trustees to return funds to customers much more quickly, as they would not have to reserve and wrangle over dubious claims of preference made on customer assets. Some members of the industry complain this change would be burdensome for FCMs seeking funding; however, this provision would simply return the operation of the law to the way it was written in 1974.

Strengthen Customer Priority by Giving Proper Statutory Authority to CFTC

In addition to enacting this subordination provision, the CFTC's current regulation Section 190.08(a)(i)(J) should simply be codified in the CEA directly to invalidate the authority argument made by *Griffin*'s judge. The regulation states that "customer property" includes . . . "cash, securities or other property of the debtor's estate, including the debtor's trading or operating accounts and commodities of the debtor held in inventory, but only to the extent that the property enumerated [above] is insufficient to satisfy in full all claims of public customers." Codifying that regulation in conjunction with enacting a subordination provision would leave no doubt as to the priority of customer funds in a bankruptcy without opening up the Bankruptcy Code, which we have been told is akin to a zombie apocalypse.

Customer Account Insurance

In testimony before the Senate Committee on Agricultural, Nutrition, and Forestry, the CCC advocated for the creation of a private insurance mechanism to cover FCM malfeasance before the uncovering of the PFGBest fraud. We agree with our colleagues here that insurance for commodity accounts is a complicated matter which requires deliberative study. The type of insurance as well as its triggers and limits are just a few of the nuances which will drastically affect the costs and benefits of such insurance; however, you do not need a study to determine that there is a type of customer who would benefit from an insurance mechanism. As MFGI Trustee Giddens noted in his *MF Global Investigation Report,* 78% of MF Global customers could have been fully insured with a $200 million fund. That amount seems to be a much easier sum to raise than the billions required by the CFTC's Residual Interest proposal. Indeed, 91.5% of commodity customers surveyed by the CCC are in favor of some type of an insurance mechanism.

Ring-Fencing New Account Classes

Finally, the addition of new, segregated account classes for retail FX customers and for safekeeping accounts is a simple legislative change that would improve customer protections for groups that are often neglected. Many in the industry view FX customers as the red-headed stepchildren of the futures regulatory regime, and argue that they do not deserve the protections of segregation if they do not trade exchange-cleared products. We beg to differ, though, and if the futures industry is

responsible for regulating retail FX, it should not expect retail customers, most of whom are also futures customers, to understand that nuanced argument. Rather, it should do its best to protect all customers by giving them segregation protections, so they do not end up as general creditors like PFGBest customers probably will, even though no theft occurred in the FX accounts there.

There has also been significant demand for safekeeping accounts, especially from mutual funds, which would allow customers to hold their excess margin in an individually-segregated account at a custodial bank rather than in a commingled segregated account at a FCM. Currently, CFTC Interpretation 10 essentially prohibits that practice, stating that such an account would still suffer a *pro rata* loss during a FCM bankruptcy for which there was a shortfall in the general segregated pool. We recommend creating a separate account class for safekeeping accounts and repealing Interpretation 10 to make the implementation of such an account class viable.

Thank you again Chairman Conaway, Ranking Member Scott, and Members of the Committee for inviting us here today. We are honored to be included in these important discussions as to how best protect commodity customers going forward.

The CHAIRMAN. Thank you, Mr. Koutoulas.

Mr. Johnson.

STATEMENT OF THEODORE L. JOHNSON, PRESIDENT, FRONTIER FUTURES, INC., CEDAR RAPIDS, IA

Mr. JOHNSON. Chairman Conaway, Ranking Member Scott, and Members of the Subcommittee. Thank you for inviting me to provide testimony regarding the customer protection rules proposed by the CFTC. My name is Ted Johnson, and I am President of Frontier Futures, a small family-owned futures commission merchant based in Cedar Rapids, Iowa. It was started by my father nearly 30 years ago to provide low cost futures execution to people who want to make their own decisions regarding their trading needs.

The vast majority of our customers are farmers or small agricultural firms who use futures markets to hedge their risks.

Today, I am here to provide the views of a small FCM on the rule changes the CFTC has proposed to protect customer funds. There have been a number of highly publicized failures by futures commission merchants in the past several years involving substantial loss of funds and shaking the confidence of many users of the markets. I have had more conversations than I can count with customers who are worried about the safety of the funds they invest with us.

All these recent failures have involved fraud or malfeasance on the part of the FCM and a failure to follow rules and regulations regarding keeping the proper amount of funds in segregation. The NFA, the CFTC, and other regulators should be applauded for the great strides they have made in the last few years using technology to verify information provided by FCMs. Prior to this, the only—we were required to report our funds in segregation to the NFA daily, but the only confirmation they received was when they came in for an annual audit. PFG showed even this could be subverted for a time. Today, our balances are independently confirmed daily, and if there is a discrepancy, I can tell you the NFA is following up on that quickly.

We have also new reporting rules regarding withdrawing funds from segregation. I fully support the rules that seek to codify these changes and to give CFTC backing to them, and I believe they will enhance public confidence in the futures markets.

The other issue is the co-customer risk that the other members of the panel here have talked about. If debit amounts from a certain customer exceed the capital of an FCM, the rest of the losses are made up by other customers of that FCM whose funds are held in these segregated accounts. To my knowledge, there has not been a case of a customer losing money due to another customer's debit since I have been in the futures industry for about 25 years.

Commission and interest income is too small when compared to the risk incurred if customer accounts aren't properly monitored to avoid debit accounts. If any markets were going to cause a problem for FCMs, last summer's volatile ag markets would have. However, at least in our case, we don't have a single customer who is unable to meet their obligations. Many of the proposed rule changes address this issue. Requiring FCMs to increase risk management standards, increasing requirements for residual interest in segregation and reduction in days to collect margin calls before they become capital charges are all aimed at protecting an FCM's customer from losses incurred by other customers of the FCM. Most of these changes have significant costs associated with them.

For an FCM—the requirement to maintain a separate risk management department is not only expensive for an FCM of our size but ignores the fact that our entire staff is, in effect, a risk management department. The requirement to maintain residual interest in segregated funds greater than all margin calls at all times would be very difficult for us to track and also will require us to choose between greatly increasing our capital or the funds we require customers to deposit. Smaller customers who are unable to meet their margin calls at a moment's notice would risk liquidation of their positions.

For Frontier Futures as a firm, the option to increase our capital may not even be possible, and the increasing margins may cause many of our customers to either leave us for others firms or cease trading all together.

The residual interest rule may also force consolidation in a number of small to mid-sized FCMs. Currently, FCMs charge margins based on requirements set by the exchanges. The new rules will create a competitive imbalance favoring firms with access to large amounts of capital, such as bank-owned FCMs, as these firms will be able to fund margin calls by their customers.

Firms without this access would be forced to charge much higher rates and may result in migration of customers out of these firms. With fewer customers available, there is bound to be consolidation. This will mostly affect the small to mid-sized FCMs who clear these small hedgers.

In the end, all government regulation should meet a cost-benefit analysis standard. Much of the discussion surrounding these rules is focused on the cost side of this equation.

In the case of the rules which enhance the ability of regulators to ensure that existing rules are followed and to prevent fraud, the FCM failures at MF Global and PFG have made the benefits clear. However, the benefits of the new rules regarding risk management and residual interest are far less clear, and the cost to the industry and end-users of the markets are real and substantial, especially smaller firms, farmers, and ranchers.

Thank you for this opportunity to comment on this issue. I look forward to answering any questions you might have.

[The prepared statement of Mr. Johnson follows:]

PREPARED STATEMENT OF THEODORE L. JOHNSON, PRESIDENT, FRONTIER FUTURES, INC., CEDAR RAPIDS, IA

Chairman Conway, Ranking Member Scott and Members of the Subcommittee, thank you for inviting me to provide testimony regarding the customer protection rules proposed by the CFTC. My name is Ted Johnson, and I am the President of Frontier Futures, Inc, a small family owned futures commission merchant based in Cedar Rapids, IA. Frontier Futures was started by my father nearly thirty years ago with the intent to provide low cost futures execution to people who want to make their own decisions regarding their trading needs. The vast majority of our customers are farmers or small agriculture firms who use the futures markets to hedge their risks.

Today I am here to provide the views of a small FCM on the rule changes the CFTC has proposed to protect customer funds. From a broad perspective, there are two ways that customer funds can be put at risk. The first is when the FCM removes funds from segregation, leaving the customer accounts under-funded. This problem has manifested itself recently as a number of highly publicized failures by futures commission merchants in the past several years involving substantial loss of funds and shaking the confidence of the end-users of the derivatives markets. I have had more conversations than I can count with customers who are worried about the safety of the funds they invest with us. This was especially true following the failure of PFG, given the fact that they were located just up the road from us in Cedar Falls, IA, and the local news coverage of the case was extensive. Our firm was also directly affected by a less publicized FCM failure in 2007 when Sentinel Management Group was discovered to have been illegally investing customer funds. In that case, the shortfall was made up by other FCMs, including Frontier Futures, who had invested customer funds with Sentinel. This cost my firm most of our capital and forced us to close one of our three offices.

All of these recent failures have involved fraud or malfeasance on the part of the FCM and a failure to follow the rules and regulations regarding keeping the proper amount of funds in segregation. The NFA and the CFTC should be applauded for the great strides they have made in the last few years in using technology to verify information provided to them by FCMs. Prior to this, we as an FCM were required to report our funds in segregation to the NFA daily, but the only confirmation they received was when they came in for an annual audit. PFG showed that even this could be subverted. Today, our balances are independently confirmed daily, and if there is a discrepancy, the NFA seems to be following up quickly. We also have new reporting rules regarding withdrawing funds from segregation, although there is no independent confirmation mechanism for this yet. Many of these proposed rules seek to codify these changes and give CFTC support to them, and I fully support these rules. Most of them involve the use of technology and procedure to greatly increase the level of protection provided to customer funds from malfeasance by their FCMs, and should enhance public confidence in the futures markets.

The second way customer funds in segregation can be jeopardized is the result of large losses by other customers of an FCM. Customers of an FCM that generate debits reduce the amount in segregation. An FCM is required to make up that debit out of its own capital until that debit is collected. This is a main reason for FCMs maintaining a residual interest in the funds in segregation. If the debit amounts are larger than the capital of the FCM, a shortfall in segregation occurs, and results in losses by other customers whose funds are held in these segregated accounts. To my knowledge, there has not been a case of a customer of an FCM losing money due to a customer debit since I have been in the futures industry. FCMs are already greatly incentivized to avoid this risk. Commission and interest income is simply too small of a percentage of the risk incurred if customer accounts aren't properly monitored and debit accounts avoided. If any markets were going to cause problems for FCMs, last summer's volatile ag markets would have. However, we did not have a single customer who was unable to meet their obligations.

Many of the proposed rule changes address this issue while FCMs are already focused in this direction. Requiring FCMs to increase risk management standards, increasing the requirements for residual interest in segregation, and the reduction in days to collect margin calls before they become capital charges are all aimed at protecting an FCM's customer from losses incurred by other customers of the FCM. Most of these changes have significant costs associated with them. The requirement

to maintain a separate risk management department is not only expensive for an FCM of our size, but ignores the fact that our entire staff is in effect a risk management department. The requirement to maintain residual interest in segregated funds greater than all margin calls at all times will not only be very difficult to track, but force us to choose between doubling or possibly tripling our capital, or greatly increasing the funds we require our customers to deposit to ensure they never have a margin call. For smaller customers, or those who can't follow the markets on a minute to minute basis, meeting margin calls on a moment's notice is a difficult thing to do. This is especially true of small hedge customers, who would then be faced with liquidation of hedges. For Frontier Futures as a firm, the option to increase our capital by that much may not be possible, and increasing margins may cause many of our customers to either leave us for other firms or cease trading altogether.

The broader consequence of the residual interest rule may be to force a consolidation in the number of small to mid sized FCMs. Currently, FCMs charge margins based on margin requirements set by the exchanges. The new rules will create a competitive imbalance favoring firms with access to large amounts of capital, such as the bank owned FCMs, as these firms will be able to fund margin calls by their customers with this capital. Firms without this access will be forced to charge much higher margin rates to their customers, and may result in a migration of some customers out of these firms. With fewer customers available to some firms, there is bound to be consolidation. This will mostly affect small to mid sized FCMs who clear small hedgers as well as guarantee Introducing Brokers.

In the end, all government regulation should meet a cost-benefit analysis standard. Much of the discussion surrounding these rules has focused on the cost side of this equation. In the case of the rules which enhance the ability of regulators to ensure that existing rules are followed and to prevent fraud, the FCM failures at MF Global and PFG have made the benefit clear. However, the benefits of the new rules regarding risk management and residual interest are far less clear and the costs to the industry and end-users of the markets are real and substantial, especially smaller firms, farmers and ranchers.

Thank you for this opportunity to comment on this issue. I look forward to answering any questions you might have.

The CHAIRMAN. Thank you, Mr. Johnson.

I also thank our panel for strict adherence to the 5 minute rule. I appreciate that discipline this morning.

The chair will remind Members that they will be recognized for questioning in order of seniority for Members who were here at the start of the hearing. After that, Members will be recognized in order of arrival. I appreciate the Members' understanding, and I recognize myself for 5 minutes.

Mr. Duffy or Mr. Roth—regarding the reinterpretation of the CEA by CFTC—they claim there is a sound legal basis for how they came to that new conclusion that they need to reinterpret the Act and change this longstanding interpretation. Can you give us your opinion as to whether or not the CFTC has a sound legal basis for that new interpretation?

Mr. ROTH. Mr. Chairman, I think the suggestion by the Commission that the statute ties their hands on this issue, that is their position, that their hands are tied because the statute provides what the statute provides. In my experience, regulators, including NFA, when they want to do something—or they don't want to do something, their hands are tied. When they do want to do something, they can untie knots quicker than a boy scout, so it strikes me as being odd that for 39 years, the Commission consistently misinterpreted the statute. And I think the suggestion that the current proposed rule is mandated by the statute flies in the face of logic to me.

I don't think, as a matter of statutory interpretation, they are correct, and I think, further, the fact that for 39 years the Commission took the other position undercuts their position.

The CHAIRMAN. All right. Thank you.

Terry, anything further?

Mr. DUFFY. I couldn't add to that metaphor, so I will leave that one alone.

Mr. CONAWAY. All right.

Mr. Johnson—or Mr. Anderson, I am sorry. Yes, Mr. Anderson.

One of the issues that is of importance to family farmers is funding, financing and providing themselves with protection from market volatility by hedging in the commodity markets. We are concerned that the CFTC has nearly finalized its customer protection rules, but the very farmers and ranchers that it is supposed to help have recently come out opposed to it. In your opinion, is the staff of the CFTC ignoring the concerns of smaller agricultural customers, despite the overwhelming concern that Congress and the Administration has expressed for the financial well-being of family farms?

Mr. ANDERSON. I am not sure if they are ignoring it, but we are all here today to make sure that that voice is getting heard. I think there is momentum. Obviously, the messages today are pretty similar, so we just want to make sure that is heard.

The CHAIRMAN. All right. Dr. Culp, thank you for your work on this insurance study. Can you spend a little time walking us through the mechanics of how a $25 million fee will grow to $2.5 billion in 2067, and why that is not necessarily a viable option?

Dr. CULP. Sure. In order to get to that particular number, there is a chart that is contained in my written testimony, made the assumption that there is no change in the gross revenues from the futures industry, from the FCMs from 2012 levels; in other words, no increase nor no decrease. So using the 0.5 percent annual contribution rate for all 70 FCMs that reported in 2012, that gets us to a $25.5 million a year number. We then assume it is invested at two percent a year and that there are absolutely zero claims or losses. In that situation, the fund would grow to $2.5 billion after 55 years.

The same thing happened with SIPC, and there is also a chart that is in my written testimony. If you look at the profile of SIPC when it was funded in the first place, the funds in SIPC grew very slowly, so had there been a very large loss early in the life of SIPC, the only thing that would have made the SIPC facility at all credible was the $2.5 billion line of credit that SIPC has with Treasury. That is why, to me, the idea of a universal government mandated fund along these lines just isn't a credible, viable option to provide capital and assurances to investors, unless it is including an implicit or explicit government backstop.

The CHAIRMAN. All right. And in the time remaining, could you flesh out a little bit why the futures market may not be well served by a model that is designed for clients in a retail equity market.

Dr. CULP. Sure. In fact, those are related issues. It is a good question. I mean, futures are risk-shifting markets. You have heard this from my other co-panelists already. Securities markets are markets for investment in capital formation. The historical role

of participants in futures markets has not been of retail investors. There is a retail component, but the vast majority of futures trading participants are commercial hedgers that are managing the risks of their businesses, institutional investors, like pension funds, *et cetera*. Often, the sizes of the accounts held by these participants are relatively large, especially compared to a $250,000 policy limit.

So, to some extent, having a retail-type government-backed fund for a wholesale sophisticated market is a bit like ramming a square peg into a round hole.

The CHAIRMAN. All right. Thank you, gentlemen.

I will have some other questions later.

Mr. Scott, for 5 minutes.

Mr. DAVID SCOTT of Georgia. Thank you very much.

Mr. Duffy, may I start with you?

I listened to your testimony and you recommend the Future Industries Association's alternative proposal to residual interest, that is, to permit an FCM to calculate its required residual interest as of 6 p.m. On the first business day after the trade date.

Mr. DUFFY. Correct.

Mr. DAVID SCOTT of Georgia. So, as we do not have the FIA here to testify, can you explain to the Committee how this proposal accomplishes what the CFTC is aiming for in its proposed rule, without the cost that everyone here has testified to?

Mr. DUFFY. Well, without having FIA here, what we are—our understanding is, and what I have talked with our risk folks and our clearing folks is, in talking with all of our FCMs, they believe that they can calculate—or they can collect somewhere in the neighborhood of 80 to 90 percent of the margin that is due by the next day.

Mr. Roth is correct. Everybody does not do wire transfers. Many still do checks, but for the most part, we can probably wire most of the money in by 6 p.m. the next day, but there is this still outstanding ten percent. So, that is really what the alternative calls for. I think what is important here, the Commission's interpretation of "at all times," you heard the gentleman to my far left make a comment about how they can't complete—they cannot comply with such a requirement, and this is a compromise that makes complete sense.

So that is really how they came up with it. We believe firmly that we can get most of the margin in by 6 p.m. the next day.

Mr. DAVID SCOTT of Georgia. Very good. Now, to you, Mr. Roth and actually, if we have time, I would like the whole panel to respond to this. Many of you highlight two particular risks to customer segregated accounts, those arising from the futures commission merchant itself and those arising from losses experienced by fellow-customers. Now, given the history of the futures market, which of these risks is greater and which risk should we be most worried about attempting to address in this CFTC reauthorization? And if I could get as many responses as we could.

Mr. ROTH. Thank you, sir. The—back in, I guess it was around 1986, NFA did a study of FCM insolvencies, going all the way back to 1938, and if you look at the whole history of FCM insolvencies, by far, the most frequent cause of an FCM insolvency is malfeasance. By far. So, the most—just in terms of frequency, the customer, or rather FCM malfeasance is the greatest risk.

In terms of magnitude of the risk, if you did have these sort of cataclysmic market events that sparked a number of defaults by major institutional customers, the magnitude of those losses that could be caused by fellow-customer risk would be far greater than what happens through malfeasance. But as far as frequency, by far, would be the malfeasance by the FCM historically.

Mr. DAVID SCOTT of Georgia. Dr. Culp, would you comment on that?

Dr. CULP. I think Mr. Roth is right. I would actually add one thing, though, that if you think about the fellow-customer risk, we actually have done analyses of these numbers, again, working with CME and the stress testing model. In order for the magnitude of fellow-customer risk to exceed the malfeasance/misfeasance risk, you would not only have to have a truly catastrophic market move but you would actually have to have a fairly large number of the customers of the FCM fail to make their margin payments. If you look at just a few hundred for a large FCM, and we went through a number of iterations of this, but if you don't have widespread failures to pay, then even the magnitude of fellow-customer risk can actually be below the misfeasance or malfeasance risk. So, I agree, I think that is bang on.

Mr. DAVID SCOTT of Georgia. All right. Now, very quickly. In previous testimony, this Subcommittee has had calls for increased penalties for market manipulation, attempted manipulation, other violations in order to better protect customers by having stronger punishment for wrongdoers. Do you agree, or do you think current penalty levels are sufficient to dissuade wrongdoing in the derivatives market?

Mr. ROTH. I am sure everybody wants to talk about that, but I will jump in first because I was quickest with the button. You know, ultimately, the strongest deterrent you can have is criminal enforcement of rules. Civil penalties are fine. They are important. But nothing is more effective than vigorous prosecution of existing laws. And it is frustrating for everybody because there are always so many competing interests for the resources of the prosecutors as well as any other facet of government, but that is really where you are going to achieve the greatest deterrent impact, is vigorous criminal prosecution of the existing laws. Civil penalties are important. I don't mean to minimize them, but nothing is more important or effective than criminal prosecutions.

Mr. DAVID SCOTT of Georgia. Well, thank you so much. I see my time has expired. Maybe we will come back, and in a second round, I can get responses from others on that.

The CHAIRMAN. All right. Thank you, Mr. Scott.

Chairman Lucas, 5 minutes.

Mr. LUCAS. Thank you, Mr. Chairman. And I thank you and the Ranking Member for this hearing and all of the work you have done on this subject matter.

And I certainly appreciate our witnesses appearing today to discuss an issue that has garnered a lot of attention.

We have been discussing the CFTC's proposed rule that seeks to improve customer protections. However, I worry that the Commission has missed the mark with much of its proposal. As currently drafted, the futures commission merchants would be forced to use

their own capital to cover all customers positions at all times of the day, in addition to farmers and ranchers that would have to meet 1 day margin requirements, and for many of our rural folks, our farmers and ranchers, a 1 day margin call is simply unrealistic.

So, I ask the group: To anyone's knowledge, have there been conversations between USDA and CFTC about the impact this customer protection rule will have on farmers?

That is what I was afraid of.

Given the vocal outcry from producers in the ag marketplace, and I ask again this question generally to the group, are you optimistic that the Commission will repropose this rule or at least make meaningful changes?

That is what I was afraid you would say. Let the record show that there was not any optimism on either question in that regard.

I just would note that I wrote a letter to the CFTC last week with the leaders of both House and Senate Agriculture Committees asking the Commission to not ignore the concerns of the small ag players in the market.

And Mr. Chairman, I would like to ask unanimous consent that the letter be entered into the record, written by myself, Ranking Member Peterson, Chairwoman Stabenow, and Ranking Member Cochran from the Senate Agriculture, Nutrition, and Forestry Committee.

The CHAIRMAN. Without objection.

[The letter referred to is located on p. 61.]

Mr. LUCAS. Thank you, Mr. Chairman.

Finally, I will ask this question, Mr. Duffy, and of course, if anyone else would care to answer. If the proposed changes to the residual interest and 1 day margin are implemented by the CFTC, what will the futures commission merchant industry look like in 5 to 10 years, and what will happen with the farmers and ranchers who they have served for decades?

Mr. DUFFY. I will give you the 5 to 10 minute version first because that is what will happen in 5 to 10 minutes. We had a meeting in Chicago, the former Secretary of Agriculture, Mr. Glickman, and myself, held with all the ag producers and all the groups from around the country, and we had everybody from NCBA to the National Farm Bureau, and they said to a person, they would be out of the market instantaneously if that was to happen.

So, I don't know what is going to happen in 5 to 10 years, Mr. Chairman, because that is a very difficult thing to try to look into the future, but I can tell you, this is a very serious issue for our farm community. We only have a handful of FCMs that they have the ability to go to today. If those FCMs are burdened with an additional cost, these participants will have nowhere to go in the marketplace except to do over-the-counter type transactions or things of that nature due to risk management. That is exactly what Dodd-Frank called for them not to do. You want them on a listed exchange doing it in the clearinghouse.

This is a critical issue for a good part of the average daily volume of liquidity for farmers and ranchers because not only does this impact farmers and ranchers, the people that create that liquidity, they will have nowhere else to go. What happens is, these spreads will widen dramatically, and when those spreads widen dramati-

cally then the producers of agricultural products will have to pass on that cost of their risk management onto the American consumer. That is not a good outcome on a very bad rule, sir so, I cannot tell you where 5 or 10 years will go. I can tell you what is going to happen in 5 or 10 minutes once this passes, though.

Mr. LUCAS. Anyone else wish to comment?

Sadly, Mr. Chairman, I think that sums it up. I yield back the balance of my time.

The CHAIRMAN. Well, I thank the Chairman and appreciate your questions this morning.

Let us now go to Gloria for 5 minutes.

No questions.

Mr. Costa for 5 minutes.

No questions.

Dr. Benishek for 5 minutes.

Mr. BENISHEK. Thank you, Mr. Chairman.

Have any of you had conversations with the CFTC about the—what is the response to your concerns? I mean, it seems like you said that our hands are—they said our hands are tied. Is that the only response that you have gotten to your inquiry about this?

Mr. ROTH. The conversations that I and others have had, you do have the response that, one, our hands are tied; this is just mandated by the statute. I think there are times when certain members of the Commission staff proposed alternatives that would extend the time at which the funds had to be in place to the end of the clearing cycle, which is like 3 a.m., the next day, and which does really no good at all.

Frankly, in response to the Chairman's question, I am kind of an optimistic guy by nature, and I think that there has been enough outcry on this that I am very hopeful that the Commission will ultimately adopt a rule that makes sense.

It takes three votes up there—I am optimistic that reason will prevail. But in conversations, it has been largely again that their hands are tied, this is mandated by the statute, and that they are willing to extend it to some point but not as far as the FIA proposal, which NFA would certainly support.

Mr. BENISHEK. Let me ask you, has there been a change? I am not familiar enough with the Commission to—has there been a change in the composition of the Commission or the staff that would result in loss of institutional knowledge or the fact that this has been interpreted one way for 39 years doesn't seem to bear any weight in the decision making process? Can you elaborate on that?

Mr. DUFFY. Yes. I think the only change, obviously, has been Commissioner Sommers, who has stepped down. The Commission has not filled that vacancy yet. They put up a nominee. The President has put up a nominee so far but yet to be confirmed, so we don't have a full complement of Commissioners. As far as staff goes, they have only made one announcement as of recently that was on the enforcement side.

On this particular rule issue, again, you said it correctly, it has been 39 years of interpreting it one way, and I believe this is what Mr. Roth said in his testimony, this is—has nothing to do with what happened to protect customer funds under MF Global or PFG. This wouldn't have done anything to prevent what MF Global did

to the marketplace. What MF Global did, we won't rehash all the things that they did, because I testified in front of this Committee and others, they committed a fraud, for the most part. And that goes with what Mr. Roth said earlier, we need to have penalties, more than civil, criminal penalties to make sure that these things don't happen again, but this rule, sir, makes absolutely no sense whatsoever from the Commission's standpoint.

Mr. BENISHEK. Thank you.

Mr. ANDERSON. I could add to that as well, though. Last Ag Advisory Committee meeting, they said the same thing, hands are tied. We have done a little bit of work, and it appears they are pulling one line out of the Commodity Exchange Act, and the very next line in there says, "*Provided, however,*" and goes on to have a list. I don't know exactly off the top of my head what that says, but we believe that "*Provided, however,*" phrase might have a little flexibility, and we included that in our written testimony as well.

Mr. BENISHEK. Does anyone else want to comment?

Well, I think I will yield back my time. Thank you.

Mr. DUFFY. Mr. Chairman, may I make one more comment, please?

I think what is really important, sir, to recognize and not get lulled to sleep by the Commission or its proposal, as I said in my testimony, and others have also, it is a phased-in proposal, where sometimes that gets very attractive where the first year there is no change and so people feel, well, we will worry about in a year from now.

This, even though it is a phased-in proposal, I assure you that people that are looking at this will not wait 1 year to see what year 2 and 3 and 4 are going to look like. They will be out of the market long before that, because what will happen is FCMs are going to have to set up business models. They can't have business models for 30 days. They have to put out a 2 or 3 year or 5 year business model. This will impact that 2 or 3 or 5 year business model if they try to implement it, so I would hope that the Congress would recognize that this 4 year implementation is no different in year 4 than it is today.

Mr. BENISHEK. Thank you, sir. I will yield back.

The CHAIRMAN. The gentleman yields back.

Austin Scott for 5 minutes.

Mr. AUSTIN SCOTT of Georgia. Thank you, Mr. Chairman.

We have heard a lot today about the things that are wrong in the proposed rule, and I am going to—Mr. Roth and Mr. Anderson, if the two of you would—what are the things in the rule that you think are right, if anything?

Mr. ROTH. There are a number of things, and we support most of the proposal. Certainly, to the extent that the Commission codifies the changes that have already been made by SROs, we are fully supportive of that. In addition, though, they require—they require FCMs to expand our test in FCM internal control. I think that is a good idea. They required FCM certified financial reports to be filed within 60 days of the firm's fiscal year-end instead of the current timeframe. I think that is a good idea. It is a harmonization step. They would require that FCMs that are undercapitalized provide immediate notice to the SROs and to the CFTC. That

is a good idea. There are a number of things in there that are a good proposal. There are others that—residual interest isn't the only interest that we had trouble with, and I recited in my testimony some of those concerns that we have, none of them as grave as with respect to residual interest, so there are a number of things in here that we fully support, and I hope the rule proposal goes forward, and I certainly hope they make the changes that they need to make.

Mr. ANDERSON. NGFA has been a big proponent of customer protections. You know, again, these two points, we have debated them here. But in general, a lot of the transparency that they are trying to bring through the new rule is positive. So we are certainly supportive, again, of most of what is proposed.

Mr. AUSTIN SCOTT of Georgia. I guess the loss of faith in the markets is just as detrimental as the increased costs that may drive people out. Either one of them can drive people out of the markets. I hope we are able to get a commonsense, good resolution that increases that transparency and does not increase the cost astronomically.

Mr. Chairman, with that said, I will yield the remainder of my time out of respect for other Members.

The CHAIRMAN. Thank you, Austin.

Randy Neugebauer, 5 minutes.

Mr. NEUGEBAUER. Thank you, Mr. Chairman.

Mr. Duffy, I enjoyed your editorial in *The Wall Street Journal.*

Mr. DUFFY. Thank you, sir.

Mr. NEUGEBAUER. You know, one of the things that I am hearing is that, does anybody support the enhanced settlement rule?

Mr. ANDERSON. Could you repeat that?

Mr. ROTH. Congressman, I am sorry, does anybody support the residual interest rule, is that the question?

Mr. NEUGEBAUER. Right. Yes, I am sorry. Yes.

Mr. DUFFY. No.

Mr. NEUGEBAUER. One of the things that I wanted to bring out, Mr. Duffy, in your day-to-day operations at the exchange, I mean, you all are monitoring market movements and where there is potential risk. I mean, it is not like you wait until 2 or 3 days later and say, what happened? Some of those things are happening in a real-time environment, are they not?

Mr. DUFFY. Congressman, they might have been happening in a real-time environment, they have been happening for a long time in a real-time environment. So we do what is considered twice daily mark to market. We can do pays and collects on an hourly basis if need be under what market conditions dictate. We spend a tremendous amount of money to make sure to police our markets not just from abuses in them, but from a risk management standpoint, and that is critically important to the health of the marketplace. So, yes, sir, we do that.

Mr. NEUGEBAUER. And, Mr. Johnson, I mean, you have customers out there, some large and some small, and with various positions out there. You are monitoring the marketplace, as you said, all of your people are basically risk managers because you are helping your clients manage their risk. But you are also managing your

risk in the sense that making sure that you will be able to meet the exchange requirements. Is that a fair statement?

Mr. JOHNSON. Yes, that is correct. I mean, the bottom line is if one of our customers is unable to meet their requirements and goes debit, it is our money that is on the line first. From that standpoint certainly we are constantly monitoring what our customers are doing, how their positions are being affected by market moves at any given time. I mean for us, as I said, our whole firm is essentially a risk management department, and we are doing that all the time.

Mr. NEUGEBAUER. Mr. Roth, you mentioned that the response from the CFTC is that their hands are tied and that they feel like there is a legal obligation for them to implement this rule. We are headed for a reauthorization period here. What legislative fix would you suggest that we look at if it appears that the Commission is going to go ahead and implement this rule?

Mr. ROTH. I think if the Commission, in fact, went forward, Mr. Anderson pointed out that there is—the qualifying language to the requirement that no one customer's funds be used to margin another customer's positions, the *Provided, however,* language that follows that, in our view, currently provides the Commission the flexibility that it needs. But if the Commission determines otherwise and goes forward with this rule, God forbid, then that is an area where Congress might be able to insert language into the Commodity Exchange Act to make clearer that the Commission's rule is invalid and not necessary.

Mr. NEUGEBAUER. Mr. Duffy?

Mr. DUFFY. If I could just add to that, what would be acceptable is, at least from CME's standpoint and the Futures Industry Association, is adopt the rule that they have put forward, which is to do trade day plus 1 at 6 p.m. And as I said earlier, we feel very confident in surveying a lot of our FCMs that the moneys can be collected 80 to 90 percent by 6 p.m. trade day plus 1.

Mr. NEUGEBAUER. Anybody else want to comment?

Mr. Chairman, with that I will yield back.

The CHAIRMAN. Thank you.

Mrs. Hartzler, 5 minutes.

Mrs. HARTZLER. Thank you, Mr. Chairman.

Dr. Culp, I was very interested in your testimony about the insurance study. And you said, given the projection that a government-mandated creation of a Futures Investor and Customer Protection Corporation would not have $1 billion in assets to protect futures customers until around 2041. Would that imply that a taxpayer-funded line of credit at the Treasury Department would be necessary for it to be viable in the foreseeable future?

Dr. CULP. That is a good question. But part of the answer to the question revolves around where the target funding level comes from. I mean, the target funding level of $2.5 billion is basically what SIPC's target funding level is. The $1 billion, I made mention of that in my written testimony because it is a nice round number.

The real question is how much do you actually need to cover big potential losses. And with a mandated universal scheme, given what the potential risks are, I find it extremely unlikely that there

would be adequate funding without a government backstop to cover a truly catastrophic loss scenario.

Part of the problem is it covers everyone. It is mandated by the government and it is universal, so that includes small customers and really large customers. Even though there is a contemplated policy limit, there is a lot of risk out there. And the advantage of the voluntary solutions is it enables the people who most value insurance to try to get the insurance that is tailored to their needs as opposed to, again, forcing the square peg into the round hole of one size fits all for the whole industry.

Mrs. HARTZLER. Now, you have used the word scheme twice, so we know where you are coming from there.

Dr. CULP. Sorry.

Mrs. HARTZLER. No need to apologize. You are the expert. And I just, from a gut level, feel like we would be establishing another Federal Flood Insurance Program, or FDIC, or some new government-backed insurance program where the taxpayer ultimately could be responsible for loss there. I appreciate your input on that. I will look forward to hearing what the insurance companies come back with as far as quotes for other options there.

But I want to move on. Mr. Anderson, first of all, I think I might have some of your facilities in my district in Missouri. Do you have any retail outlets in my district?

Mr. ANDERSON. No, our retail outlets are all in northwest Ohio, Toledo area.

Mrs. HARTZLER. Oh, well, that is all right. I wanted to ask you a question, though. Your testimony highlights the points that had the CFTC's proposed rule been in place when MF Global failed, possibly twice as much customer money, the hard-earned money of many farmers and ranchers would have been lost. So how must the CFTC change its proposed rule in order to avoid such a stark possibility from happening in the future? I believe Mr. Duffy said something about criminal penalties earlier. I don't know if both of you want to respond, but if you want to start, Mr. Anderson, and then Mr. Duffy.

Mr. ANDERSON. Sure. You know, frankly, we have supported going back to the consistent interpretation that has been there, which would allow a lot of the futures industry to continue operating as it has. That is our opinion. And FIA also had a proposal a little bit different than that, but either of those will keep—the goal is really to keep the FCM from asking for money upfront——

Mrs. HARTZLER. Yes.

Mr. ANDERSON.—to cover that move that may or may not come. If we can go back to the consistent interpretation that we have always had, that would suffice.

Mrs. HARTZLER. Okay. Mr. Duffy, do you want to add anything, go back to the——

Mr. DUFFY. Actually, I was only emphasizing the point that Mr. Roth made, he said it earlier about the civil and criminal penalties.

Mrs. HARTZLER. Okay.

Mr. ROTH. I am sorry, did you need to hear more than that?

Mrs. HARTZLER. Sure.

Mr. ROTH. Just the point, the question is whether we should increase the civil penalty sanctions that the CFTC can impose, and

my only point was that civil sanctions are very important, but in my experience the most effective deterrent to wrongful conduct by far is not civil penalties, but criminal penalties. And so ultimately you have to enforce the rules that are on the books and get criminal prosecutions when people steal money.

Mrs. HARTZLER. Okay. Yes, do you want to add something?

Mr. KOUTOULAS. Just to add to Mr. Roth, the rule is already on the books that any willful violation of the Commodity Exchange Act is a felony and bears up to 10 years in prison. The CFTC has already brought a civil enforcement act against the CEO of MF Global. We think that the Department of Justice should go ahead and bring criminal prosecutions along the same vein. And we also think that the Department of Justice needs to investigate the misrepresentations made by MF Global senior management before this Committee and other Committees when testifying about their conduct in the days leading up to the bankruptcy.

Mrs. HARTZLER. All right. Thank you very much.

Thank you, Mr. Chairman.

The CHAIRMAN. I thank the gentlewoman.

Mr. LaMalfa, 5 minutes.

Mr. LAMALFA. Thank you, Mr. Chairman.

For Mr. Johnson here, earlier you testified how your family has been around 30 years in the business, and you work primarily with the smaller firms, the smaller growers. And you already went through some difficulty obviously back in 2007 because you were caught up in that, you had to close one of your offices. What was the impact on the number of personnel because of that, or in general since then, with the changes in rulemaking, *et cetera?*

Mr. JOHNSON. Well, in that case we closed one of our three offices, which had about 25 percent of our staff, total staff, and that was as a result of—we have talked a lot about the two main FCM failures here, the PFG and MF Global, and that was another FCM failure which didn't result in any customers losing money but a number of other FCMs who had money invested there did lose money, and we were one of those.

Mr. LAMALFA. Okay. If CFTC rules are adopted as proposed for your operation, how much would you have to alter or are you one of the ones that in 10 minutes is in big trouble?

Mr. JOHNSON. Well, that is a possibility. For us, because we are a very small FCM, we clear a lot of our business at, for instance, the CME through another FCM. So it will depend a little bit on how they treat it. If they force us to double or triple our margins, we will initially have to do that to our customers, and then it becomes an issue. I don't think that we would be gone in 5 or 10 minutes. In our case it would be a question of how many of our customers are going to leave us because of that.

Mr. LAMALFA. Will they have a better place to go under those conditions then, it would be more attractive to go to a larger?

Mr. JOHNSON. It may be if they can find a larger FCM that is even willing to clear them.

Mr. LAMALFA. Yes.

Mr. JOHNSON. In a lot of cases with many of our smaller customers, the larger FCMs aren't even interested in doing business

with those people. So a lot of them may just decide to leave the futures markets altogether——

Mr. LAMALFA. Completely.

Mr. JOHNSON.—which is a problem for them and for the industry as a whole.

Mr. LAMALFA. Certainly. Certainly.

Mr. Duffy, we are hearing about a proposal from the White House to impose a transaction tax on the operations of CFTC. Now, we have seen similarly that the SEC's budget over a decade has practically doubled. What do you see if this tax is imposed and there is a larger budget for CFTC, what do you see happening in the future there with that additional requirement for a budget for CFTC and what they are going to be doing with it as far as enforcement?

Mr. DUFFY. I think that the user fee question and the CFTC budget question and the SEC has doubled their budget, obviously, Professor Culp mentioned the difference between capital formation and risk management. Capital formation you can go ahead and charge a per share stock, per transaction fee to fund the SEC because most people will hold on to a share of stock much longer than they will a derivative product, and you have many more participants in the marketplace to make it up, so it is much easier.

In our world there is not nearly as many of the liquidity providers that are in the marketplace, and right now our highest liquidity providers that are standing there all day long creating tight bid offers, in order to get the $300 million that the CFTC has proposed, there would have to be a 4.5¢ charge to our largest liquidity providers to raise that $300 million annually. That is a 70 percent increase in their cost of doing business to provide liquidity.

If, in fact, you charge any business a 70 percent increase in cost to do business, they are going to do one of two things. They are going to figure out how to lay off that risk to somebody else or that cost to somebody else, and the only way market makers could do that is to widen their bid offer as I talked earlier. So if, in fact, we were to impose a transaction tax or a user fee on the participants of liquidity providers, the bid offer spread would widen, so the producers of products of grains and livestock and products like that, those costs would either be out of the market and have to be assumed themselves, passed on to the consumer.

And there is one thing that is really important here, Congressman. The United States Treasury has an auction every week, and at that auction every week, as you know, the yields have not been very great, but they are aggressively in there bidding for them. The reason people can aggressively bid for the United States auction every week is because there is a liquid futures market to lay that risk off. If that spread widens in the futures market because the cost of business goes up by 70 percent, the amount that will cost to taxpayers in facilitating that debt will go up by billions and billions of dollars because those spreads will widen. That will force the yield to go up on the Treasury debt.

So this is one of the most penny-wise, dollar-foolish things I have ever seen in my entire life. We have seen user fees, just as an example being in India, just this past summer, absolutely destroyed their market by 25 percent. Sweden 20 years ago imposed a trans-

action fee; they no longer are a financial services center whatsoever. In Europe there was a Tobin tax proposed, as we all know. That Tobin tax has not been implemented and been watered down to basically nothing throughout the rest of Europe and will not even apply to derivatives.

So there are big issues associated with these markets, how fragile liquidity can be and what the cost of liquidity can be.

Mr. LAMALFA. I appreciate that answer. My time is up, but thank you.

Mr. DUFFY. Thank you, sir.

The CHAIRMAN. All right. Mrs. Roby for 5 minutes.

Mrs. ROBY. Thank you, Mr. Chairman.

Thank you all for being here today.

We have touched on this, Mr. Johnson, but I really want to drill down and if you could elaborate. If the industry consolidates as a result of the proposed rule, let's talk about the little guys, what the impact is going to be on small farmers and agricultural firms that make up most of your customers, if you would.

Mr. JOHNSON. Well, as I stated earlier, most of our customers are small farmers, maybe some larger farmers or small agricultural firms. The issue with a consolidation of the FCM industry is that for the most part the larger FCMs, especially the bank-owned FCMs, are not interested in doing business with really small customers. From their standpoint, doing the risk management on a small customer is really about the same amount of work as it is on a large customer in terms of time and staff and things like that, and yet the benefits that they get from those larger customers are a lot greater.

You know, from our standpoint, we have been doing business with our customers for years. I mean, we will celebrate our 30th year next year. Many of our customers have been with us for a long time, a large portion of that time. Our order desk staff averages between 15 and 20 years of experience in the industry. So we know our customers, we are able to do the risk management on those customers in an efficient way.

If a firm like us were to no longer be able to do business because a number of our customers left us for some reason, I believe that a lot of them would have a very difficult time finding another place to do business or, if they did, the business would be a lot more expensive for them. They would either be required to put up a lot more margin or pay a lot higher commissions to other firms to cover their costs in terms of doing the risk management and things like that.

But the real issue is that the small FCMs, the midsize FCMs like us are the ones that do the farmer business, and those are the ones that are most at risk.

Mrs. ROBY. Sure, thank you very much.

And, Mr. Anderson, can you elaborate as well what the consequences for your business and your customers if the CFTC's proposed rule on the customer protections is finalized with no changes?

Mr. ANDERSON. Sure. The double margining—we think that is a reasonable conclusion, it is going to drive up our cost of doing business. When we buy grain from the farmer, we sell futures on the

Chicago Board of Trade or CME Group, and now it is going to cost us twice as much to do that. We typically pass on some sort of fee to the farmer, so it is either going to come to them on the front end or, we are a low-margin business, so we will look to make a little more margin to offset some of those fees. And I don't think that is unique among the elevator industry. I think that people will look to recoup that cost one way or another.

Mrs. ROBY. Thank you again for all being here today.

Mr. Chairman, I yield back.

The CHAIRMAN. I thank the gentlelady.

Mr. Davis for 5 minutes.

Mr. DAVIS. Thank you, Mr. Chairman.

And thank you to all the witnesses. Raise your hand if you are from Illinois. Let the record show. Thank you, Mr. Enyart. Let the record show that four witnesses raised their hand being from the great State of Illinois. I just wanted to gloat to my fellow colleagues how important the State of Illinois is to this issue.

The CHAIRMAN. Gloating was noted and offensive.

Mr. DAVIS. Thank you. Duly noted, sir. Offending the Chairman is probably not a good way to start the hearing today, is it?

But a lot of questions have been asked. And, Mr. Duffy, to start with, I enjoyed your expanding on the White House's proposal for the transaction tax. Are there any other issues you would like to address on that particular question that you may not have had time for?

Mr. DUFFY. Other than—this is one of those fees—I was asked this in the United States Senate a couple months ago—if the industry is not going to pay for it, who should pay for it? And it is a very difficult scenario to say.

This is one of those situations where we are talking that the CFTC is looking for funding because they have to have oversight of $641 trillion over-the-counter business. I like to remind Congress that the $640 trillion over-the-counter business has less than 2,000 transactions a day. We don't measure risk in notional value; we measure it in the amount of transaction and participants in the marketplace. We do 15 to 20 million transactions in the futures markets today; we trade over a quadrillion dollars of risk on an annual basis. I mean, that is 17 zeros, Congressman, so that is a lot of risk. And we have been doing that flawlessly for many, many years. So I don't think we can measure the amount of funds associated with an agency on the notional value of the contracts.

Second, I think that any time we look to impose user fees, the detriment that that could do, like I said earlier, I mean, if you want to charge an industry $300 million, unfortunately you are going to charge the taxpayers several billion dollars of the offsetting cost that people will pass on to the users, not just in the Treasury debt facilitation, but in the price of wheat, corn, barley, livestock, and everything else because it will have to go up if there is no risk management or the cost of risk management goes up. So this is essential for the food supply of the United States of America.

Mr. DAVIS. I agree, and thank you very much.

One other question. I mean, obviously MF Global has been an issue that has been discussed already in most of the testimony and

in some of the questions. What is CME's role in facilitating the processes that are being put in place to avoid another MF Global situation?

Mr. DUFFY. Mr. Roth and I both have outlined several things in our testimony, both orally and written, and I think that these are new things that have not had a chance to be fully either implemented but let's see the full value of them, and that is what is important here. We have put many new protections in, and Dan said it right, the look-through into the customers' balances is something that we didn't have before, which if we had had the electronic look-through before, PFG wouldn't have happened or would have been discovered much earlier.

First of all, with all due respect, Congressman, you can put a cop on every corner and somebody is going to still try to commit a crime. There was falsified records associated with MF Global. I don't want to debate all the facts, we have done that many times in this Committee and others. The good news is that there are many new protections for the clients today, and if we can have the deterrent that Mr. Roth referenced where we have criminal penalties associated with some teeth in it, that would be the most important thing.

Mr. DAVIS. Thank you.

And last, obviously we have heard through your testimony, Dr. Culp and others, that if customers are unwilling to purchase private insurance, that a government-mandated program funded by market participants might be a viable option.

Mr. Duffy, I have seen your testimony, you disagree with this, and can you expand on that, too?

Mr. DUFFY. Yes, I am not big on government-mandated programs. I don't think they are good. I like the private sector answers better. If people want to have an opt-in insurance policy that they want to pay for, I have said it before in public testimony, that should be their right to do so.

I will tell you, Congressman, we have a $100 million fund set aside for farmers and ranchers for this type of activity, so if there is any type of fraud or things of that nature, we will pay *bona fide* hedgers, which we have done in PFG's case, where we didn't even have the obligation to do it because we weren't even a DSRO for PFG, but we paid them out on that particular program.

That $100 million, think about that, that is not a lot in a business that has got multibillions under management. We have $105 billion of margin on account. That $100 million was uninsurable from a practical standpoint. So I can't imagine how we could ever get a scheme together—I don't want to use the word scheme again—but a scheme together to put together enough money to oversee the system. And the last thing that I or anybody at CME Group would support would be to have a government backstop.

Mr. DAVIS. Thank you. My time has expired.

The CHAIRMAN. The gentleman's time has expired.

Mr. Enyart, any questions?

Mr. ENYART. I will waive my time to Mr. Scott. I have no questions.

The CHAIRMAN. The gentleman yields to Mr. Scott for 5 minutes.

Mr. DAVID SCOTT of Georgia. All right. Thank you.

Let me go back. I want to make sure we get everybody on the record on this. Does everybody agree? I think, Mr. Duffy, you concur that we should have criminal charges being brought, you spoke to that. Is that correct?

Mr. DUFFY. Yes, sir.

Mr. DAVID SCOTT of Georgia. All right.

And, Mr. Roth, you gave an eloquent answer.

What is interesting is, Mr. Chairman, you put such a nice diverse panel here, it would be good to see if we could get everybody on board on that, so I put that question to everybody pretty quickly. To really protect the customers and to punish these violators and manipulators, do you all agree or disagree with Mr. Roth and Mr. Duffy that we should bring criminal charges and that that would help this if we could put some of these folks in prison, and that would cut it down? Is everybody on board with that or is somebody different?

Mr. ANDERSON. NGFA, we haven't recommended any specific penalties, but we certainly believe there needs to be appropriate teeth in the law. We just haven't quite advocated exactly what we mean by that yet.

Mr. DAVID SCOTT of Georgia. So you do not agree that we should bring criminal charges?

Mr. ANDERSON. Today we would not have enough information to say yes or no to that.

Mr. DAVID SCOTT of Georgia. All right. Mister—I do not want to murder your name. What is it?

The CHAIRMAN. Koutoulas.

Mr. DAVID SCOTT of Georgia. Koutoulas.

Mr. KOUTOULAS. Koutoulas. Perfect.

Mr. DAVID SCOTT of Georgia. Thank you, I am sorry.

Mr. KOUTOULAS. Not at all. Thank you.

We believe that the current law is there to bring criminal charges for MF Global, we believe there is a mountain of evidence to support that, as Mr. Duffy alluded to, and we think the bringing of criminal charges would do a lot to restore confidence in the futures markets.

Mr. DAVID SCOTT of Georgia. Very good.

And Mr. Johnson?

Mr. JOHNSON. Well, I certainly believe that any time that somebody commits fraud or steals money from their customers they deserve to be criminally charged.

Mr. DAVID SCOTT of Georgia. Thank you. Thank you very much on that.

Now, Mr. Anderson, let me ask you, in your testimony you call for a pilot program of a customer option for a fully segregated account structure to be set up, but by the industry itself and not through legislation, correct? But the point is, if Congress fails to make changes to the Bankruptcy Code clarifying that customer funds in segregated accounts are always first in line for disbursement, then does a fully segregated account structure really provide much additional protection?

Mr. ANDERSON. That is a very good question, and it is going to come down, like you said, to the Bankruptcy Code and where those assets lie.

The reason for a pilot program is maybe to see a little bit of how that would work as well with those funds being completely fully segregated away from the FCM, how does that work, how do the mechanics work, what are the costs associated with it. I think some time needs to be spent on the law as well.

Mr. DAVID SCOTT of Georgia. Okay.

Dr. Culp, in your testimony, you mentioned that over the long history of the futures industry few customer funds have been lost either from the failure of futures commission merchants or losses arising from the result of fellow-customer risk exposures. That is until recent events with MF Global and Peregrine Financial Group.

On the securities side, the Securities Investors Protection Corporation has initiated at least 325 proceedings under the Securities Investment Protection Act to recover cash or securities for customers, and approximately $120 billion have been distributed back to customers over SIPC's 42 year history, $1.1 billion of that from the SIPC Fund. And as you have researched the possibility of some kind of futures insurance fund like SIPC Fund, have you found any explanation for why over time we have seen far more instances of customer losses on the securities side than we have seen on the futures side?

Dr. CULP. I can say that wasn't a question that we specifically addressed in the study, but from my familiarity with the markets it goes a little bit to an earlier comment, the fundamental difference between securities and futures and the constituents of those markets. Many of the investors in securities markets are investors, they are buy-and-hold stock purchasers, and a lot of the claims that the SIPC has encountered over time have been related to the fact that there are different risk managements and controls in place in securities than there are in futures. For example, the at least twice daily margining that Mr. Duffy mentioned, that is not something that we do in securities markets. We do that in futures markets. And there is a litany of other risk managements and controls.

But it is easy to think securities and futures are more similar than they are. They are actually very, very different in a lot of ways. And although, like I said, I didn't research this for this study, I am pretty convinced that is the answer.

Mr. DAVID SCOTT of Georgia. Thank you, sir.

I yield back.

The CHAIRMAN. Thank you, Mr. Scott.

First off, I ask unanimous consent to enter into the record the written statement from the Managed Funds Association. Without objection, so ordered.

[The information referred to is located on p. 61.]

The CHAIRMAN. Dr. Culp, one of the criticisms of the insurance product was that you have a disproportionate burden of the funding of this thing *versus* the risks being protected based on a 0.5 percent fee on gross transactions for everybody. Did you look at other funding models that would be more in line with risks covered being paid for by that risk? In other words, is there any possible way of scaling the fee structure back to cover just the $250,000 that is the gross of the account, other funding models?

Dr. CULP. Just to clarify, you mean in a universal mandated scheme?

The CHAIRMAN. Yes, universal mandated scheme.

Dr. CULP. No. You know, we thought about it. The problem is there are a lot of different possibilities. So for the mandated universal coverage scheme we focused on the proposal that is out there. Part of the problem with the scenario-based approach that we used is you can come up with an almost endless number of potential scenarios, so we tried to focus on the ones that were most likely to be proposed.

The CHAIRMAN. So, in other words, the $2.5 billion in reserves that you think are needed to cover the scheme in 50 years, whatever, covers just the $250,000 per account risks?

Dr. CULP. Yes, sir.

The CHAIRMAN. So you pull the folks whose assets are beyond $250,000 and not charge those a fee. The fee would be such that it just makes no rational sense at all to get to the $2.5 billion, if you billed your fee just to the activities within the $250,000 accounts and less?

Dr. CULP. Then it would be even harder to get to that target number, substantially so.

The CHAIRMAN. Okay.

Mr. Roth, I have two questions regarding your initial confirmation of account balances prior to the failure of PFG Best. One, there was some evidence that the owner there had been falsifying the bank statements provided to you on a daily basis. Could you reverse that now and falsify the confirmation? In other words, you are comparing the balances confirmed by the FCM as to segregated accounts with what the bank says is there.

Mr. ROTH. Correct.

The CHAIRMAN. And so could this fellow have falsified the records that you are comparing to, to cook the books, just the reverse of what PFG did?

Mr. ROTH. Yes, Congressman, I am never going to suggest that there is a silver bullet which prevents——

The CHAIRMAN. No, no, I am not suggesting that. I am just saying, but at least the second question is, after the PFG issue your organization went through an extensive review of your own process and own audits.

Mr. ROTH. Right.

The CHAIRMAN. Can you walk us through that?

Mr. ROTH. Yes. We actually retained a group, the Berkeley Research Group, and the principals of the Berkeley Research Group are the same individuals that performed a study for the SEC on the Madoff study. And we asked them to come and review the entire history of NFA's dealings with Peregrine in particular, and to review all the examinations that we had done. And in the course of their study they reviewed three million pages of documents going over our entire history, and they made a number of really helpful suggestions. They basically found that the exams that we had performed were professionally and competently done but that we need to do better, and we are incorporating all of those suggestions.

And the core suggestion really is to just always inculcate an attitude of professional skepticism in your staff. We have had all of our

staff now, anyone who has been at NFA in the Compliance Department for more than a year will have to go through a certified fraud examiner training process to try to, again, develop and nurture that sort of attitude of professional skepticism of always trying to view every possibility of uncovering fraud.

The CHAIRMAN. All right. And the idea that if I am the FCM and I am stealing out of my segregated account, and I send the NFA a falsified document, but, I am tracking what is actually there. I have been stealing from customers.

Mr. ROTH. Right.

The CHAIRMAN. I send you the document that says, here is what I think is in the account. You get from the bank a confirmation that that is where I have stolen. But how do you catch me stealing from the account?

Mr. ROTH. Well, if you are claiming to have $200 million in the bank and the bank says that you have $5 million——

The CHAIRMAN. I have that part. If I say I have $200 million, and the bank says I have $200 million, but I really should have had $400 million.

Mr. ROTH. Yes. So that is when you are undercounting your assets and underreporting your assets, and what we do to try to address that issue is in the examination process we do confirmations with customers. So on a select basis.

The CHAIRMAN. Okay.

Mr. ROTH. But you test certain customers and say the firm is reporting that you have X. Do you in fact have X? That can't be done on a daily basis, but it is part of the examination process.

The CHAIRMAN. Right. I got you. I appreciate that.

One question that we haven't really touched much on is the CFTC's attitude toward cost-benefit analysis on proposed rulemaking. David and I and, quite frankly, the Committee is working toward strengthening those cost-benefit analysis procedures at the CFTC. Can any of you or all of you comment on your experience with—not that we are going to retread or redo Dodd-Frank, but I have plenty of anecdotes where the CFTC said, here is what we think it will cost the industry or the participants to comply with this rule, and it has turned out to be a multiple of that number in most instances. Can you talk to us about what your attitude is about the cost-benefit analysis attitude at the CFTC and how they are mechanically going about it one more time?

Mr. ROTH. This may not be particularly helpful, but——

The CHAIRMAN. Well, then, don't say it. Just kidding.

Mr. ROTH. The rulemaking process within NFA is that we develop rules and you are always trying to develop rules that are cost-effective, and we just get input directly from the industry. And as part of our rulemaking process when we have to deal with our advisory committees and our board of directors and we have to go to the industry professionals and say this is the public policy we are trying to achieve, this is how we are proposing to do it, they would give us real good and real direct input about what the costs are. So in NFA we get that input directly from the industry as part of the rulemaking process, and it is very, very helpful.

The CHAIRMAN. But in terms of what the CFTC has done through the Dodd-Frank implementation and their ability to use

cost-benefit as a part of their decision-making process as to what rules to put in place or what rules not to put in place, *i.e.,* the residual interest information this morning, did the CFTC look at the concerns that you talked about as a part of their deliberations to get to their rule that they think is appropriate?

Mr. ROTH. I don't know what their internal deliberations were, but I can certainly tell you that they didn't have any contact with NFA where they asked us for our input on that topic.

The CHAIRMAN. Mr. Duffy?

Mr. DUFFY. There has been a tremendous amount of comment letters filed on this particular issue, and obviously the Congressional testimony, so the final rule is yet to be voted on. So hopefully the cost-benefit analysis that you are referencing, they are taking all the comment letters along with this Congressional hearing and taking that into account, which will come up with a decision that is yet to be made. So hopefully, we are getting a little ahead of ourselves yet, and to Chairman Lucas' point earlier, we may not have a lot of faith, but at the same time we do need to let the process go through.

The CHAIRMAN. All right.

Other Members on the Committee have questions? Yes, David.

Mr. DAVID SCOTT of Georgia. Let me follow up a little bit on our bill, H.R. 1003, cost-benefit analysis, which is very important. The President in his Executive Order has ordered all those agencies to do cost-benefit analysis for rulemaking. The CFTC, being the primary regulator, or making joint rulemaking with the SEC, for example, they have assessment and cost-benefit analysis before each. However, again, I just make this comment, that the CFTC doesn't have enough staff right now to do what it is that they are doing.

And so I just urge each of you, and each of you have your own constituencies, that we have to increase the funding of the CFTC. If we don't, it is going to hurt all of us. No matter, we could pass all these bills and all these regulations that put it on it, and it needs to be. But this needs to happen, but we need to give the CFTC the tools with which to work right now. Right now they are bleeding people.

So I just make an appeal to you in the industry to join with many of us here in these real tight budgetary times. Right now the government is shut down. Right now we are running the government by crisis. I mean, I don't know how long this is going to go on.

But this is a primary example of what I am talking about that brings about the uncertainty, unassuredness that we have. And I always am taking the opportunity to push and hope people will hear, not like John the Baptist in the wilderness, but I guarantee you, I am asking for you all to join with me in that and say, look, doggone it, let's give the CFTC the money they need, not pour this load on them, so they can do the job that we absolutely need.

And finally, the other reason we need this is to be able to put the CFTC in a stronger defense position for any lawsuits or legal activity, for if they had the cost-benefit analysis requirement to back themselves up, they would be more in a better position to sustain these outward charges and lawsuits.

Yes, Mr. Duffy?

Mr. DUFFY. Mr. Scott, so I don't leave any misimpressions, I have been on the record and the CME has been on the record for many years that we do believe that the CFTC needs to be adequately funded. So we wholeheartedly support what you are saying.

We have one of the more dynamic businesses in the United States. If you look at the growth rate of the listed derivatives, regulated derivatives business in the United States over the last 40 years, it has been just exploding, and it has benefited farmers, ranchers, bankers, all the different people—mortgage people—that use the marketplace. These are all benefits to the United States of America.

So we agree with you wholeheartedly that it needs to be fully funded and it is absolutely essential to do so. So we echo your comments. And I hope we didn't leave the impression that we don't think it should be funded to a proper level.

Mr. DAVID SCOTT of Georgia. Thank you very much.

Anybody else? Yes, Mister——

Mr. KOUTOULAS. Ranking Member Scott, we agree also wholeheartedly that the CFTC needs adequate funding, especially when you contemplate the implementation of Dodd-Frank and essentially that the industry is building a new regulatory regime for cleared swaps essentially from scratch.

I will give, I guess, an anecdote as to the attitude inside CFTC when it comes to managing funds, that we met with just about every Commissioner to discuss the conversion of MF Global's holding company to a Chapter 7. And we continuously got the response, why would you do that? Just let the trustee handle it. And, I mean, they just didn't seem to grasp how expensive relying on the three different trustees that were there in MF Global was. And after testifying last February at the roundtable on customer protections regarding residual interest, staff really did not seem to grasp just how expensive that proposal would be for the industry and how damaging it would be to the gentlemen on my left and right.

I think a little bit of attitude adjustment is required, but more funding would go a very long way to helping them fulfill their mission.

Mr. DAVID SCOTT of Georgia. Thank you very much.

Thank you, Mr. Chairman.

The CHAIRMAN. I thank our witnesses.

And, David, do you have any kind of closing remarks, anymore John the Baptist references or anything?

Mr. DAVID SCOTT of Georgia. This has been a very effective hearing and very enjoyable. I have learned a lot from it, and you did a good job in getting a great diversified group from different areas, although most of them are from Illinois.

The CHAIRMAN. Well, I also want to thank all the witnesses, including the ones from Illinois. We will do a little better job of looking for Texas witnesses next time perhaps.

But on a serious note, I appreciate each of you coming in. I know there was some uncertainty this week about whether or not we would have this hearing. There may be those out there that criticize Dave and I for going ahead and having this hearing in the face of the shutdown.

It is our constitutional responsibility to reauthorize the CFTC. It is better off if we reauthorize it than if we don't, and this hearing is integral to that. We would not be able to get your comments and the written record established had we not had the hearing today, if we moved forward with the reauthorization at the pace that we are going to try to move forward with, so David and I made a decision to go ahead and hold the hearing. And I appreciate the witnesses taking their time to come share that with us this morning and look forward to folding your comments into our markup and the rules and the bill that we will do in terms of the reauthorization.

So with those comments, I again thank the witnesses for being here. And under the rules of the Committee, the record of today's hearing will remain open for 10 calendar days to receive additional material and supplementary written responses from the witnesses to any question posed by a Member.

This hearing of the Subcommittee on General Farm Commodities and Risk Management is adjourned. Thank you.

[Whereupon, at 10:48 a.m., the Subcommittee was adjourned.]

[Material submitted for inclusion in the record follows:]

SUBMITTED LETTER BY HON. FRANK D. LUCAS, A REPRESENTATIVE IN CONGRESS FROM OKLAHOMA

September 25, 2013

Hon. GARY GENSLER, *Chairman;*
Hon. BART CHILTON, *Commissioner;*
Hon. SCOTT O'MALIA, *Commissioner;*
Hon. MARK WETJEN, *Commissioner;*
U.S. Commodity Futures Trading Commission,
Washington, D.C.

Dear Chairman Gensler and Commissioners Chilton, O'Malia and Wetjen:

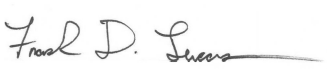
We write regarding concerns that have been brought to our attention with the Commodity Futures Trading Commission's (CFTC) November 14, 2012, proposed rule to improve protections for futures customers. While we support your efforts to protect customers in the futures markets and believe the Commission's proposal contains needed reforms, we have also heard from a wide variety of farmers, ranchers and small-to-medium sized futures commission merchants (FCMs) who argue that parts of the rule could dramatically change their business models and prohibitively increase costs.

We certainly recognize that the failures of MF Global and Peregrine Financial Group inflicted terrible losses on futures customers, many of whom were farmers and ranchers merely seeking to hedge their commercial risks. We are pleased that the CFTC, self-regulatory organizations, industry trade groups, FCMs, and market participants have worked together in the interim to strengthen customer protections.

However, as you work to finalize the rule on customer protections, we ask that you weigh the benefits of these regulations against both the costs to America's farmers and ranchers and the potential impact on consolidation in the FCM industry. In making this determination, carefully consider the consequences of changing the manner or frequency in which "residual interest"—the capital an FCM must hold to cover customer positions—is calculated. The goal of increasing futures customer protections should be to strengthen the markets without harming the ability of American farmers, ranchers, and end-users to hedge their legitimate business risks.

Our Committees place a high priority on the concerns of the agricultural marketplace. We urge you to take these views into account as you review and vote on a final rule.

Sincerely,



Hon. FRANK D. LUCAS,
Chairman,
House Committee on Agriculture;

Hon. DEBBIE STABENOW,
Chairwoman,
Senate Committee on Agriculture, Nutrition, and Forestry.

Hon. COLLIN C. PETERSON,
Ranking Minority Member,
House Committee on Agriculture;

Hon. THAD COCHRAN,
Ranking Minority Member,
Senate Committee on Agriculture, Nutrition, and Forestry.

SUBMITTED STATEMENTS BY HON. K. MICHAEL CONAWAY, A REPRESENTATIVE IN CONGRESS FROM TEXAS

MANAGED FUNDS ASSOCIATION

Managed Funds Association ("**MFA**") is pleased to provide this statement in connection with the House Agriculture Subcommittee on General Farm Commodities and Risk Management's hearing held on October 2, 2013 on "The Future of the

CFTC: Perspectives on Customer Protections". MFA represents the majority of the world's largest hedge funds and is the primary advocate for sound business practices and industry growth for professionals in hedge funds, funds of funds and managed futures funds, as well as industry service providers. MFA's members manage a substantial portion of the approximately $2.375 trillion invested in absolute return strategies around the world. Our members serve pensions, university endowments, and other institutions.

MFA's members are among the most sophisticated institutional investors and play an important role in our financial system. They are commodity pool operators ("**CPOs**") and commodity trading advisors ("**CTAs**"), which are customers of futures commission merchants ("**FCMs**"). Our members are active participants in the commodity and securities markets, including over-the-counter ("**OTC**") derivatives markets. They provide liquidity and price discovery to capital markets, capital to companies seeking to grow or improve their businesses, and important investment options to investors seeking to increase portfolio returns with less risk, such as pension funds trying to meet their future obligations to plan beneficiaries. MFA members engage in a variety of investment strategies across many different asset classes. The growth and diversification of investment funds have strengthened U.S. capital markets and provided investors with the means to diversify their investments, thereby reducing overall portfolio investment risk. As investors, MFA members help dampen market volatility by providing liquidity and pricing efficiency across many markets. Each of these functions is critical to the orderly operation of our capital markets and our financial system as a whole.

MFA appreciates the Subcommittee's thoughtful review of and focus on customer protection issues. We supported financial reform and policymakers' goals to improve the functioning of the markets and to protect customers by endorsing central clearing of derivatives, increasing transparency and implementing other measures intended to mitigate systemic risk. We also appreciate that Congress remains vigilant about and has held hearings related to the MF Global, Inc. ("**MF Global**") and Peregrine Financial Group, Inc. ("**Peregrine**") insolvencies. Our members have investors in their funds; and are customers themselves, and therefore, we remain deeply troubled by the MF Global and Peregrine events and the consequences of their insolvencies.

Accordingly, we support thoughtful legislative and regulatory changes to strengthen protections of customers. We believe some additional refinements to the Commodity Exchange Act ("**CEA**") and the regulations of the Commodity Futures Trading Commission ("**CFTC**") would further fulfill the Subcommittee's objective to enhance protections for customers.

In these respects, we believe Congress should: (1) encourage the CFTC to finalize its proposed rules on enhancing customer protections with certain modifications intended to bolster the rules' efficacy; (2) amend the Bankruptcy Code to help shield the collateral of cleared swaps customers from another MF Global or Peregrine-like failure; (3) encourage the CFTC to repeal the prohibition on futures customers' use of third-party custodial accounts as a mechanism to protect their collateral; and (4) amend the CEA by adopting stronger protections for confidential information.

MFA appreciates the Subcommittee's consideration of this written statement. As customers and active participants in the derivatives markets, we are committed to working with the Congress, the CFTC and other interested parties in addressing customer protection issues.

CFTC Rules on Enhancing Customer Protections

MFA strongly supports the CFTC's issuance of proposed rules on enhancing customer protections (the "**Proposed Rules**"),[1] and the CFTC's efforts to ensure adequate protection of customers and their funds by augmenting the requirements imposed on FCMs and enhancing the oversight of FCMs. As customers in the derivatives markets, we applaud the CFTC for recognizing the potential weaknesses in the current customer protection regime and proposing thoughtful measures to increase the protection and confidence of customers. We ask the Subcommittee to support the CFTC in finalizing the Proposed Rules with certain modifications that we, as customers, believe would assist Congress and the CFTC in furthering its customer protection goals.

Residual Interest Requirement

MFA agrees with the CFTC that the timely collection of margin is a critical component of an FCM's risk management program, and that it is important to require FCMs to bold sufficient funds to protect against insufficient margin in customer ac-

[1] 77 *Fed. Reg.* 67866 (November 14, 2012).

counts. However, from a practical perspective, we are concerned about the CFTC's proposed residual interest requirement, which would require an FCM to maintain its own funds "at all times" in an amount sufficient to exceed the sum of all of its futures customers' margin deficits.

MFA emphasizes that it supports the retention of the residual interest requirement. However, as proposed, the continuous "at all times" nature of the residual interest requirement would not provide FCMs sufficient time to collect margin from their customers. The unintended result for customers is that it could significantly increase our operational burdens and costs because, to ensure compliance with the residual interest obligation, FCMs might require their customers to pre-fund their margin obligations or to meet intraday margin calls.

MFA views both of these outcomes as troubling and an unacceptable imposition on customers. In particular, it would create margin inefficiencies by causing customers to reserve assets to pre-fund their obligations or in anticipation of intraday margin calls, and thus, reduce the amount of assets that customers have to use for investment or other purposes.

As a compromise, to preserve the residual interest requirement (which we agree is important) while avoiding the negative impact and burdens on customers, MFA recommends that the Subcommittee encourage the CFTC to finalize the Proposed Rules but modify the proposed residual interest requirement so that it is not a continuous real-time obligation, but rather a "point in time" obligation. We believe the appropriate "point in time" is close of business Eastern Time on the business day after the FCM issues a customer's margin call, which is consistent with current margin practices and infrastructure. This approach would eliminate the need for customer pre-funding or intraday margin calls, while also ensuring that FCMs hold sufficient funds to protect one customer from another customer's shortfall or margin deficit.

Disclosure of FCM Information to Customers

MFA strongly supports the CFTC's proposals that would require FCMs to provide enhanced reporting and disclosure of certain information to customers and the public. Increasing the transparency of customers and the public into the operations, accounts, policies and procedures of FCMs is crucial because it would place customers in a better position to assess an FCM's stability, and if customers identify concerns and deem it appropriate, to transfer their positions and funds to a different FCM. Customers also would be in a better position to assist the CFTC and designated self-regulatory organizations ("**DSROs**"), that supervise FCMs for example, by alerting the CFTC or DSRO to customer concerns with the FCM or the FCM's decisions. Therefore, MFA believes that, in the aggregate, the enhanced disclosure in the Proposed Rules will give customers comprehensive information about FCMs' risks, and allow them to make meaningful judgments regarding the appropriateness of using a particular FCM.

In light of the importance of FCM disclosures to customers and the public, MFA believes that additional public disclosure of certain FCM information (*i.e.,* in addition to what the CFTC has proposed in the Proposed Rules) will be beneficial to the market. In particular, as the CFTC is finalizing the Proposed Rules, we ask the Subcommittee to encourage the CFTC to mandate that FCMs make publicly available each month their computations for, and compliance with rules related to, segregated customer collateral as well as FCMs' summary balance sheets and income statement information for the most recent twelve months.

MFA believes that imposing such a public disclosure obligation on a monthly basis is important because an FCM's financial stability may change significantly in a short amount of time. Therefore, we believe less frequent disclosure to the public is insufficient from a customer protection perspective.

Protection of Customer Collateral

Protection of Cleared Swaps Customer Collateral

MFA supports efforts to strengthen the legal framework applicable to collateral for customers related to cleared swaps transactions with FCMs. As mentioned, MFA remains concerned about the MF Global and Peregrine Financial insolvencies. The misuse or misplacement of customer funds in those situations resulted in customers experiencing a delay, in some cases a significant delay, in the return or outright loss of substantial amounts of their assets. Therefore, we believe that Congress should amend the Bankruptcy Code to bolster the protection of customer collateral.

Under current law, if an FCM becomes insolvent, all of the collateral of the FCM's cleared swaps customers would be aggregated and distributed to each customer on a *pro rata* basis. Therefore, even when a customer was not at fault, if there is an insufficient amount of cleared swaps customer collateral available in the FCM's cus-

tomer account to repay all customers who posted collateral, the customer would lose a portion of its posted collateral. To remedy this concern, we urge Congress to amend Chapter 7 of the Bankruptcy Code so that, upon an FCM's insolvency, customer assets posted as collateral on cleared swaps transactions would not be subject to *pro rata* distribution. Such an amendment would ensure that cleared swaps customers do not share in any shortfall due to the FCM's or another customer's default.

An amendment to the Bankruptcy Code also would enhance the effectiveness of existing and potential segregation protections for cleared swaps customers. For example, the CFTC has adopted the "legally segregated operationally commingled" model ("**LSOC**") for cleared swaps, which should generally reduce the likelihood of there being a customer asset shortfall in certain FCM default scenarios. However, uncertainty remains as to how LSOC will perform in an FCM insolvency. An amendment to the Bankruptcy Code, as discussed above, would alleviate this uncertainty and further assure the protection of non-defaulting customers in certain FCM default situations.

In addition, market participants are continuing to consider other enhancements to customer protections, such as optional full physical segregation of customer collateral. This arrangement would allow a customer to put its collateral in an account with a custodian or other third party in the customer's name, rather than have the customer's FCM hold its collateral directly, and thus, protects the customer in the event that its FCM or another customer becomes insolvent. Without a Bankruptcy Code amendment, however, a cleared swaps customer's physically segregated collateral might be considered part of the pool of customer assets of the insolvent FCM, and thus, distributed on a *pro rata* basis. Therefore, MFA believes that, if Congress amended the Bankruptcy Code, it would significantly enhance customer protection.

Protection of Futures Customer Collateral

In light of the MF Global and Peregrine failures, MFA feels it is also appropriate for the CFTC to re-examine the protections available to participants in the futures market, and to assess the appropriate balance between the costs of enhanced protections *versus* the costs to investors and the market as a whole of a segregation failure. As mentioned, we appreciate that the CFTC is working on proposals to enhance customer protections. As a further step, we think that the Subcommittee should encourage the CFTC to hold one or more roundtables, as the CFTC did when considering segregation rules for cleared swaps, to ensure full consideration of the lessons learned, and to assess whether further protections of the collateral of futures customers are appropriate.

In addition, MFA believes that the Subcommittee should encourage the CFTC to repeal CFTC Staff Segregation Interpretation 10–1 ("**Interp. 10–1**"), which prohibits futures customers from holding their collateral in accounts at a third-party custodian, rather than with their FCM counterparty. Although the CEA already requires an FCM to maintain all customer collateral separate from the FCM's own funds, it is also important that futures customers have the right to maintain their collateral remotely from their FCM counterparties at a third-party custodian. Allowing futures customers to use third-party custodial is an important step towards safeguarding customers' assets because those accounts would: (1) protect one futures customer from another futures customer's default; (2) protect futures customers from FCM operational and investment risk; and (3) facilitate the prompt transfer of futures customers' positions and collateral upon their FCM counterparty's default.

Some of our members already have third-party custodial accounts in place in the OTC derivatives market for collateral they have posted on uncleared swap positions. Moreover, when the CFTC adopted LSOC for cleared swaps, the CFTC clarified that the prohibition on the use of third-party custodial accounts contained in Interp. 10–1 does not apply to collateral posted by cleared swaps customers. MFA believes that there is no difference between cleared swaps and uncleared swaps on the one hand and futures on the other that supports retaining Interp. 10–1 for futures and limiting futures customers use of third-party custodial accounts. Rather, it is important that all customers have equal protection of their collateral regardless of what products they trade.

Therefore, MFA requests that the Subcommittee encourage the CFTC to repeal Interp. 10–1 for futures and allow futures customers to use third-party custodial accounts to ensure that the collateral that futures customers post is protected in a manner that is robust and equal to the protections available to swaps customers.

Strengthening Protections for Confidential/Proprietary Information

Reports of Commodity Pool Operators and Commodity Trading Advisors

MFA believes that Congress should strengthen the confidentiality protections for proprietary data in the CFTC's possession. MFA consistently has supported reason-

able reporting requirements to ensure that regulators have meaningful data upon which to make sound policy decisions, but it is critically important that our members know that in fulfilling their reporting obligations, their proprietary portfolio and other confidential information is appropriately safeguarded. Market participants—whether hedgers or investors—invest significant research, time and resources into developing proprietary hedging or investment strategies. Such trading strategies are proprietary information; the CEA and other statutes have recognized the legitimate commercial need to protect the confidentiality of such information.

At the same time that the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 ("**Dodd-Frank Act**") required members of the Financial Stability Oversight Council ("**FSOC**"), including the CFTC, to collect sensitive and confidential data for the purpose of assessing financial stability, it also included important provisions directing FSOC members to maintain the confidentiality of such data. The Dodd-Frank Act specifically amended the Investment Advisers Act of 1940 to protect the confidentiality of reports that the SEC requires for SEC-registered investment advisers, but no corresponding amendments were made to the CEA for CFTC reports. Such amendments would be appropriate to ensure that consistent confidentiality protections would extend to the reports, documents, records and sensitive and proprietary information of CPOs and CTAs.

The current inconsistency between the confidentiality protections afforded to reports by investment advisers as opposed to reports by CPOs and CTAs creates two potential difficulties. First, it may expose data from CFTC-regulated entities to greater risk of public disclosure. Second, it creates a potential unlevel regulatory playing field, disadvantaging the CFTC in its efforts to collect, analyze, and share data. For example, we note that the SEC and CFTC have jointly adopted Form PF for certain reporting obligations. A dually registered entity filing Form PF with the SEC would have greater confidentiality protection than if the entity filed the exact same report with the CFTC. To afford confidential information consistent treatment for CPOs and CTAs as well as investment advisers, we recommend that the Subcommittee consider amending section 8 of the CEA by extending these important Dodd-Frank Act protections for sensitive or proprietary information to CPOs and CTAs.

Protection of the Identity of Traders and the Confidentiality of Trade Data

MFA believes that Congress should amend the CEA to strengthen the confidentiality requirements for registered swap data repositories ("**SDRs**") and other regulated market utilities, such as self-regulatory organizations, swap execution facilities ("**SEFs**"), designated contract markets ("**DCMs**"), and derivatives clearing organizations or clearinghouses ("**CCPs**") (collectively, "**Regulated Entities**") to protect customer information—specifically, the identity of traders and the nature of their trading activities. In particular, these confidentiality protections must explicitly extend to swap transaction data reported to SDRs under the CFTC's data reporting rules. Our concern is not hypothetical; we are aware of instances where the confidentiality of customer trade data at SDRs was compromised. As a result of the failure of confidentiality protections, market participants may have had access to, and could have traded upon, confidential information of competitors and counterparties.

The specifics giving rise to these concerns are best illustrated under the CFTC's final SDR rules, wherein it is clear that an SDR must protect the confidentiality of reported swap data and may not disclose it to market participants. However, the same rules provide an exception to this prohibited access rule, allowing a party to a particular swap to have access to "data and information" related to such swap. The final SDR rules do not define the broad phrase "data and information".

For swaps that are traded anonymously on DCMs and SEFs and then cleared in accordance with the CFTC's straight-through processing requirements, the CCP or DCM/SEF reports the swap transaction data and information to the SDR, which includes the identity of the two original counterparties. If either one of those counterparties is then permitted to discover the identity of the other by accessing information at the SDR, notwithstanding the anonymous nature of the original trade, the confidentiality of that market participant's trading positions and/or investment strategies is breached. Such disclosure would harm competition, and would impair the smooth transition to anonymous trading on DCMs and SEFs.

Another source of data disclosure risk stems from the sheer volume of data that the CFTC is now processing and analyzing from SDRs. While the CFTC's access to such data no doubt presents an opportunity for unprecedented regulatory insight into the derivatives markets—which we support—we are also mindful that it creates another source of disclosure risk if data confidentiality and integrity are not rigorously protected by the CFTC's policies, procedures and internal controls.

Accordingly, MFA recommends that Congress amend the CEA to clarify the CFTC's and each Regulated Entity's obligations to maintain the confidentiality and integrity of swap trade data and the consequences of failures to perform this obligation. MFA further urges the Subcommittee to use its oversight to ensure that both the CFTC and Regulated Entities have appropriate safeguards to preserve the confidentiality of sensitive customer information and data furnished to regulators and Regulated Entities.

Finally, we are alarmed at reports from this spring that academics have had access to confidential trading data and trading messages from the CFTC. According to these reports, the academic used this information to reverse-engineer trading strategies and published their findings in academic journals. We commend CFTC Chairman Gary Gensler for requesting that the CFTC Inspector General investigate this matter. We believe this disclosure is a fundamental violation of confidentiality and urge the Subcommittee to review the CFTC Inspector General's findings and the steps the CFTC agrees to take to enhance its policies and controls with respect to non-public information.

MFA has prepared a *White Paper* outlining its concerns regarding protection of confidential information and submitted it to all members of the Financial Stability Oversight Council. We include a copy of that *White Paper* as an *Appendix** to our testimony.

Conclusion

MFA appreciates the Subcommittee's focus on, and the CFTC's efforts to enhance, the protection of customers. To further this effort and strengthen these protections, we believe that Congress should encourage the CFTC to finalize the Proposed Rules with certain modifications, amend the Bankruptcy Code to protect cleared swaps customer collateral, encourage the CFTC to repeal the prohibitions in Interp. 10–1 for futures, and provide stronger protections for customers' confidential information. MFA is committed to working with Members and staff of the Subcommittee as well as regulators to ensure that customer protections under our legislative and regulatory system are appropriately robust, extensive and effective.

Thank you for the opportunity to provide you a written statement of MFA's views on customer protection issues. MFA would be happy to answer any questions that you may have.

STATE STREET GLOBAL EXCHANGE

State Street is pleased to submit this statement in connection with the House Agriculture Subcommittee on General Farm Commodities and Risk Management's hearing held on October 2, 2013 on "The Future of the CFTC: Perspectives on Customer Protections."

As an initial comment, I commend Chairman Conaway, Ranking Member Scott, and the Subcommittee for the careful consideration of customer protection issues and how the future decisions by the Commodity Futures Trading Commission ("CFTC") will impact the markets.

State Street is one of the world's largest custodial banks and processors of derivatives transactions, and we support regulations which will benefit our customer base of large, buy-side, institutional investors, such as pension funds, mutual funds, and endowments. We support regulations designed to enhance customer protections in the event of a failing futures commission merchant ("FCM").

State Street believes a customer should have the opportunity to opt for greater protection of its cleared swaps and futures collateral in the event of an FCM bankruptcy by electing to hold collateral in a tri-party custodial account that is exempt from *pro rata* distribution in the event of an FCM failure. This type of account fully segregates a customer's collateral by placing it in a specified account with a custodian rather than being in the FCM's customer omnibus account. This creates a solid protection of those funds in the event of attempted misuse or fraud by the clearing member such as those recently experienced during the failures of MF Global and PFG Best. However, without a change to the Bankruptcy Code, it does not protect those funds in the event of bankruptcy of the FCM. In order to provide the fullest protection offered by a tri-party custodial account, the Bankruptcy Code must be amended to exempt collateral held in such an account from the definition of "cus-

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*The document referred to is retained in Committee file. It can also be found at *https://www.managedfunds.org/wp-content/uploads/2013/05/MFA-Data-Confidentiality-paper-final-5-22-13.pdf*.

tomer funds" and, therefore, from *pro rata* distribution in the event of the bankruptcy of an FCM.

As an initial matter, implementation of a robust customer protection framework requires both regulatory and legislative action. On the regulatory front, tri-party accounts are permissible for cleared swaps under CFTC rules, permissible for uncleared swaps, and permissible for both futures and swaps in Europe. These accounts have proven effective in offering enhanced protections for customer funds across these markets. However, tri-party accounts are not currently permitted in the U.S. futures market per CFTC Amendment to Financial and Segregation Interpretation No. 10–1, making them an outlier from how the rest of the world's derivatives markets function. State Street strongly supports permitting the use of tri-party accounts in futures for the same reasons as it is permitted in uncleared and cleared swaps and, therefore, believes the CFTC should repeal Interpretation No. 10–1. We have submitted a formal comment letter supporting this repeal to the CFTC and continue to work with the Commission as it evaluates how best to address the issue.

On the legislative front, a statutory change is also required to offer the fullest level of protection possible for customer funds through tri-party accounts. The CFTC's legally segregated operationally commingled ("LSOC") release noted that Bankruptcy Code Section 766(h) (which provides for *pro rata* distribution) likely would apply to swaps customers. If the LSOC model performs as designed, any losses created by a customer default will be absorbed by the derivatives clearing organization ("DCO") rather than the non-defaulting customers of the FCM, and non-defaulting customers would be expected to receive their full account equity in the FCM's bankruptcy distribution. However, losses caused by FCM theft or market losses on investments of customer funds would be subject to *pro rata* distribution in bankruptcy and would thus affect all FCM customers.

It is of utmost concern to State Street that customer funds held in a tri-party custody account could be subject to *pro rata* distribution without a change to the Bankruptcy Code. That means that a customer availing itself of the opportunity to increase protection of its collateral by using a tri-party account could still see its funds distributed in the event of an FCM bankruptcy because those funds, without a change to the Bankruptcy Code, are considered "customer funds." Individuals with these accounts will not benefit from the full protections that tri-party arrangements could offer if the funds are subject to such distribution. Therefore, to ensure that the customers and the benefits tri-party accounts offer are protected, we believe that the Bankruptcy Code should be amended to exclude collateral held in tri-party custody accounts from the customer funds that are subject to *pro rata* distribution in the event of an FCM failure.

Again, State Street strongly believes in the importance of protecting customers from another customer or an FCM default. We are willing to assist the Subcommittee in any way possible to ensure that customer funds held in tri-party custodial accounts are protected to the fullest. Thank you for the opportunity to provide you a written statement of State Street's views on customer protection issues. State Street would be happy to answer any questions that you may have.

SUBMITTED QUESTIONS

Response from Hon. Terrence A. Duffy, Executive Chairman and President, CME Group, Inc.

Questions Submitted By Hon. K. Michael Conaway, a Representative in Congress from Texas

Question 1. Mr. Duffy, as we all know, the failures of MF Global and PFGBest deeply rattled confidence in the futures markets. To the extent you are able, could you please update the Committee on the status of the return of customer funds, and please describe the CME's role in facilitating or expediting this process?

Answer. ***MF Global: Status of return of customer funds:***

CME Group ("CME") understands that, on November 6, 2013, the Bankruptcy Court granted the motion of James Giddens, Trustee for the liquidation of MF Global Inc. ("MFGI"), for an advance of funds from the general property of MFGI in order to permit 100% payment of all commodity customer account claims, and that a related motion is now pending in the District Court. Former officers of MFGI and others have appealed the Bankruptcy Court's decision, and the Trustee has recently indicated that "the appeal of the allocation motion [is] the only barrier to 100 percent recovery by every single commodities and securities customer."

We further understand that in the interim, the trustee is continuing to make additional distributions to customers using customer funds as they become available

to him. It is our understanding that most customers who traded on U.S. exchanges (4d) have received a 98% distribution, and most customers who traded on foreign exchanges (30.7) have received a 78% distribution.

CME Group Efforts:

Our efforts in the wake of MFGI's misconduct speak to the level of our commitment to ensuring our customer's confidence in our markets and our role in facilitating the return of customer funds:

- *Guarantee for SIPC Trustee*. CME Group made an unprecedented guarantee of $550 million in order to accelerate the distribution of funds to customers, thereby giving the trustee and Bankruptcy Court comfort that interim distributions to customers could be authorized without waiting for a reconciliation of MFGI's customer records and claims.
- *CME Trust Pledge.* CME Trust pledged virtually all of its capital—$50 million—to cover potential customer account losses due to MFGI's misuse of customer funds.
- *Customer Distributions.* CME personnel invested thousands of hours developing and implementing an unprecedented plan to transfer MFGI customer accounts and related customer assets to other commodity brokers, as well as making the interim distributions of customer assets that were authorized by the Bankruptcy Court and trustee in 2011. CME also was able to deliver to the trustee in a usable format the significant customer account reconciliation and transfer data that CME accumulated as part of this process, thus helping the trustee to resolve customer claim amounts on a highly expedited basis.
- *2012 Agreement with MFGI Trustee.* On August 12, 2012, the Bankruptcy Court approved an agreement between the trustee and CME Group that provided for the distribution of approximately $130 million of MFGI proprietary assets, on which CME and its members otherwise held superior claims, to MFGI customers. As part of that agreement, CME agreed to subordinate its otherwise valid claims to all claims of MFGI customers until they were paid in full.
- *2013 Agreements to Expedite Payments to Customers.* On November 6, 2013, CME Group, the Customer Class Representatives in the ongoing MFGI multidistrict litigation, and trustee announced agreements that will further help expedite payments to MFGI's former customers. Of the $29 million claim CME will be allowed to assert against MFGI after all customers are paid in full, which claim is based on unpaid obligations and expenses incurred by CME as a result of MFGI's bankruptcy, CME has agreed to deliver $14.5 million, ½ of the distribution that it will receive from the trustee, to the Customer Representatives for distribution to MFGI's former customers. The agreements are subject to court approval before they can become effective.
- *CME Group Family Farmer and Rancher Protection Fund.* On April 2, 2012, CME Group launched the CME Group Family Farmer and Rancher Protection Fund to protect family farmers, family ranchers and their cooperatives against losses of up to $25,000 per participant in the event of future shortfalls in segregated funds. Farming and ranching cooperatives also will be eligible for up to $100,000 per cooperative.

PFG: Status of the Return of Customer Funds:

As you may know, Peregrine Financial Group Inc. ("PFG") was not a CME clearing member, and traded on CME Group exchanges through accounts maintained at a CME clearing member. The National Futures Association ("NFA") was PFG's designated self-regulatory organization, or DSRO.

According to the bankruptcy trustee's Status Report of August 8, 2013 (published on the NFA website (*www.nfa.futures.org*)), in the fall of 2012, the trustee made an interim distribution which represented a return of approximately 30% to all domestic futures (4d) customers and 40% to all foreign futures (30.7) customers. The trustee anticipates another interim distribution in the near future.

In addition, even though PFG was not a CME clearing member, CME determined to permit family farmers and ranchers who maintained accounts at PFG to submit claims to the CME Group Family Farmer and Rancher Protection Fund. Eligible family farmers and ranchers received payments of up to $25,000 per loss, and more than $2 million was distributed by the CME Group Family Farmer and Rancher Protection Fund to family farmers and ranchers who had accounts at PFG.

Question 2. Mr. Duffy, in order to provide customers with increased protections without possibly eliminating an entire segment of the marketplace that has served farmers and ranchers for decades, what should a revised version of the CFTC's rule look like?

Answer. CME Group and the agricultural community opposed the residual interest rule proposed by the CFTC because it would have required futures commission merchants ("FCM") to insure that each customer's account is fully collateralized "at all times," which cannot be calculated in real time. Firms would have been required to double their customers' margin requirements or to contribute very large sums as "residual interest" on their behalf. The rule would have made business unsustainable for many firms that serve the agricultural community, and might have deprived them and their customers of access to futures markets. We and many others supported a compromise to permit an FCM to calculate and meet its required residual interest as of 6:00 p.m. ET the next day.

We are pleased that the 6:00 p.m. ET next day deadline is the approach adopted by the CFTC in the final rule beginning next November 2014. But we continue to oppose the portion of the final rule that will eventually move this deadline to 7:30 a.m. CT the next day. This change will happen automatically at the end of the rule's 5 year phase-in unless the Commission acts by rulemaking to propose a different deadline. But the rule does not compel the CFTC to take any action, or even to consider the results of its self-mandated study on the rule's impact, before the 7:30 a.m. CT deadline is implemented.

The final rule, which seems to pre-determine the outcome of the study, dismisses our concerns that the rule will adversely impact customers and fundamentally change the way in which futures markets operate without justification from a risk management standpoint or otherwise. These concerns have been echoed by others in our industry, participants in our agricultural markets and Members of Congress alike.

If this rule is automatically implemented in 5 years' time without change, practically, the firms that serve the agricultural community will have no ability on that "next day" to receive payments from customers who are promptly meeting their margin calls. They will have no choice but to require their customers to prefund margin or contribute residual interest on their behalf in order to comply with the morning deadline. This will unnecessarily increase the costs of hedging especially for farmers and ranchers using our markets. We will have achieved no balance between the CFTC's aim to further protect customers and the rule's adverse impact on customers and market structure.

Response from Christopher L. Culp, Ph.D., Senior Advisor, Compass Lexecon

Questions Submitted By Hon. K. Michael Conaway, a Representative in Congress from Texas

December 3, 2013

Hon. K. MICHAEL CONAWAY,
Chairman,
Subcommittee on General Farm Commodities and Risk Management,
Committee on Agriculture,
Washington, D.C.

Dear Chairman Conaway:

Thank you for providing two supplemental questions for the record regarding my testimony at the public hearing held on October 2, 2013 ("The Future of the CFTC: Perspectives on Customer Protections"). My responses to your questions are below.

Question 1. According to your testimony, your analysis suggests it would take 55 years for a government mandated SIPC-like fund to reach a target amount of $2.5 billion, and would in fact not even reach the $1 billion mark until 2041. What would happen to the timeframe of reaching these benchmarks if the FCM industry is consolidated or fewer customers participate in the markets to manage their risks?

Answer. Our calculations were based on the following assumptions: (i) the Futures Investor and Customer Protection Corp. ("FICPC") Fund would not experience *any* claims resulting from failures of under-segregated FCMs over the projection period; (ii) assets in the FICPC Fund would be continuously reinvested at a rate of two percent per annum; and (iii) total annual contributions to the FICPC Fund by all futures commission merchants ("FCMs") would be $25,521,389 (based on the actual annual gross revenues for 2012 reported by all FCMs) and these funds would be contributed once each year.[1] Under these "base case" assumptions, the FICPC Fund

[1] Specifically, 0.5 percent of gross revenues from commodities across all FCMs reporting positive gross revenues for the year 2012 was $25,521,389.

would not exceed $1 billion until 29 years after its inception and would not reach its target funding level of $2.5 billion until 55 years after its inception.[2]

As your question suggests, assumption (iii) depends on gross revenues from commodities for FCMs remaining constant over the projection period, which might not be the case. If increases in transaction costs (*e.g.,* the costs to FCMs of mandated FICPC contributions that are passed along to customers) precipitate a reduction of customers that manage their risks with futures, gross revenues of FCMs would almost certainly decline, which would result in smaller total contributions to FICPC and an even slower rate of accumulation of assets in the FICPC Fund.

For example, a $1 million reduction in annual contributions to FICPC (*i.e.,* a $200 million reduction in total gross revenues from commodities across all FCMs) would increase the time for FICPC to achieve its target funding threshold by approximately 1 year. In other words, with $24,521,389 in total funds paid in by FCMs each year (*i.e.,* $1 million less than 2012 levels), the FICPC Fund would not have more than $1 billion in assets until 30 years after its inception (as compared to 29 years based on actual 2012 gross revenues) and would not reach its target $2.5 billion funding amount until 56 years after its presumed 2013 inception (as compared to 55 years in the base case).

The larger the reduction in aggregate gross revenues from commodities across FCMs, the more pronounced is this effect. For example, if aggregate gross revenues from commodities across all FCMs fell by $5 million *vis-à-vis* 2012 levels, it would take 34 years for the FICPC Fund to cross the $1 billion threshold (*i.e.,* 5 years longer than the base case) and 62 years to reach the $2.5 billion threshold (*i.e.,* 7 years longer than the base case). And if aggregate gross revenues from commodities for all FCMs is $10 million lower than 2012 levels, FICPC would not reach its target funding amount of $2.5 billion for 72 years.

You also asked about the potential impact of consolidations across FCMs. In principle, if such consolidations do not result in a loss of customers, total gross revenues from commodities (and, hence, total FICPC contributions) would only change to the extent that different FCMs have different fee structures. If consolidations precipitate a change in gross revenues (either as a result of changes in numbers of customers, changes in per-customer fees, *etc.*), FICPC contributions would change accordingly. Without knowing how consolidations would impact gross revenues, however, it is difficult to say what the net impact would be.

Question 2. Dr. Culp, can you please help the Committee better understand the "first-loss layer" component of the risk retention group option to protect futures customers—does that mean that the FCM industry would come together as a group to pay the first layer of losses up to a certain point if an FCM failed in the future? Would the amount of losses be predetermined, or depend on the size of the failure?

Answer. The first-loss layer is essentially a deductible on the *reinsurance* policy that an industry FCM captive or risk retention group would purchase. In the proposal submitted by the Futures Industry Customer Asset Protection Co. ("FICAP"), the reinsurance syndicate would provide $250 million in total reinsurance in excess of the first $50 million in payments made by FCMs participating in the FICAP risk retention group. This amount does *not* depend on the size of the loss and is a fixed amount based on the reinsurers' assessments of the underlying risk exposure.

Under this scenario, only customers of FCMs participating in FICAP would be eligible to receive customer asset protection insurance ("CAPI") coverage. Suppose ten FCMs agreed to participate in the FICAP risk retention group. Under the terms of the FICAP proposal, customers of any one of those ten FCMs that fails while under-segregated would have access to a maximum of $50 million per FCM failure up to a total maximum across all FCM failures in one policy year of $300 million. The first $50 million in losses arising from the failure of one or more of those ten FCMs would be paid *by the FICAP risk retention group.* The reinsurance would then cover all losses in excess of the first $50 million per policy year up to $300 million.

For example, suppose one FCM of the ten that participate in FICAP fails while under-segregated, and that failure results in a total loss of customer assets (after recoveries by the bankruptcy trustee) of $25 million. Customers of that failing FCM would be fully covered for the $25 million in losses. Those $25 million of CAPI claims would be in the first-loss layer. FICAP thus would have to pay that $25 million out of its own resources; the reinsurance would not cover any of those losses. By contrast, suppose two FCMs fail in a single policy year, and that losses at each FCM equal $50 million (after recoveries), or a total of $100 million in losses for FICAP participating FCMs. In that case, the first $50 million of claims would be

[2] In this instance, I round the estimated 54.58 years up to 55 years.

paid by FICAP out of the first-loss retention, and the next $50 million would be paid by the reinsurance.

As to your question, the first $50 million in losses in the first-loss layer would likely be financed by a combination of paid-in capital contributions of the FCMs participating in FICAP and loans to FICAP from external investors. FCMs and other futures industry market participants that are *not* participants in FICAP would *not* be responsible for covering any of the $50 million first-loss layer. Only those FCMs whose customers have CAPI policies written by FICAP would be required to provide part of the $50 million first-loss layer.

The FICAP proposal did not indicate exactly how much of the $50 million first-loss layer would have to be financed with capital contributions from the participating FCMs. The reinsurers would insist on *some* commitment of funds by participating FCMs to the first-loss layer in order to align the incentives of participating FCMs with the reinsurers and to encourage prudent risk management. Yet, the FICAP proposal indicated that there is interest by outside investors to loan the FICAP entity a portion of the $50 million. This means that small FCMs with relatively small capitalization levels would not need to pre-fund the entire first-loss layer. Regardless of the proportion of the first-loss layer funded by FCMs participating in the captive *vis-à-vis* the proportion financed by external investors, FCMs that do not participate in FICAP and whose customers do not benefit from the CAPI coverage provided by FICAP would not be required to contribute anything to cover any CAPI payments or FICAP losses.

Chairman Conaway, please do not hesitate to ask for further clarification if my responses above are unclear or to pose any additional questions. I appreciated the opportunity to testify before your Subcommittee and welcome the opportunity to provide any further information you would like to review in your analysis of these issues.

With my best regards, I remain

Yours sincerely,

CHRISTOPHER L. CULP, PH.D.

Response from Michael J. Anderson, Regional Sales Manager, The Andersons Inc.; on behalf of National Grain and Feed Association

Question Submitted By Hon. K. Michael Conaway, a Representative in Congress from Texas

Question. Among your recommendations to improve customer protections are that the CFTC should have the ability to appoint its own trustee in the event of an FCM bankruptcy. Why is this important?

Answer. Our recommendation in no way is intended as a criticism of the trustee in the MF Global situation. To the contrary, we believe James Giddens and his staff have done excellent work recovering futures customer funds and distributing them back to their rightful owners. Rather, we believe it would be advantageous in a situation like MF Global where the vast majority of assets affected were those of futures customers to have authority to appoint a trustee familiar with the futures industry and issues faced by futures customers.

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