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TESTIMONY OF THE
NATIONAL GRAIN AND FEED ASSOCIATION
TO THE SUBCOMMITTEE ON
GENERAL FARM COMMODITIES AND RISK MANAGEMENT
COMMITTEE ON AGRICULTURE
UNITED STATES HOUSE OF REPRESENTATIVES

OCTOBER 2, 2013

Good morning, Chairman Conaway, Ranking Member Scott, and members of the subcommittee. I am MJ 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.

<u>CFTC's Customer Protection Proposal -- Customer Protection and Customer Risk</u>

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 <u>increase</u> 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 three 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 three-day period would be shortened to just one 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 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.

<u>Widespread Concern in U.S. Agriculture and Agribusiness</u>

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 two 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.

<u>Insurance or Liquidity Protection for Commodity Futures Customers</u> – 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.

<u>It is important to note that the solution on insurance to protect customers is not necessarily a government solution or a legislated solution</u>. 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.

<u>Fully Segregated Customer Accounts/Pilot Program</u> – 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 two 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.