Statement of
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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 underfunded. 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.