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 co-edited 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. 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). 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 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

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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.
unrelated to their futures trading activity. In those situations, the customer accounts" 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. 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. 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

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.
experienced losses resulting from Griffin’s inability to cover the losses of its defaulting customer. 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 defaulted 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.

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). 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.

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

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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 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.
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 non-profit organization formed in response to the bankruptcy of MF Global.13 There are a few exceptions, however, between the RRG proposal we

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.

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 10 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. Of those 10 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. 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

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.
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. We completed our stressed analyses of potential fellow-customer losses in late August 2013. The completed Study will summarize and present all of the relevant loss estimates that were computed for under-segregation and fellow-customer risk.

We then provided various loss exposure analyses to 10 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”). 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 10 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

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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.

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

**Figure 1: FICPC Fund Projected Asset Levels**

![Figure 1: FICPC Fund Projected Asset Levels](image)

*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

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.