Commodity Customer Coalition

Recommendations for the 2013 Re-Authorization of the Commodity Exchange Act

Presented to the Senate Committee on Agriculture, Nutrition & Forestry
May 2013

Written By:
James L. Koutoulas, Esq.
John L. Roe

Contents

SUMMARY

The Commodity Customer Coalition ("CCC") recommends that the Committee consider amending the Commodity Exchange Act ("CEA") as follows:

- Codify a first priority right for customers over all assets of an insolvent FCM's estate;
- Require that FCM residual financial interest in the customer segregated account be held in a separate but related account;
- Establish a specific criminal penalty for segregation violations;
- Increase the severity of civil monetary penalties for segregation violations;
- Provide for a Customer's Committee to represent the interests of customers in bankruptcy proceedings;
- Establish a separate account class for retail forex customers;
- Establish a separate account class for alternative segregation arrangements;
- Give the CFTC the authority to determine the appropriate liquidation proceeding for an insolvent FCM;
- Examine whether or not the CEA excludes the National Futures Association ("NFA") from using a portion of its member assessments for a customer protection fund; and
- Give the CFTC authority to bring criminal prosecutions.

The CCC still advocates for the creation of a customer protection fund or an insurance mechanism, though we do not believe such a fund should derive its authority from the CEA.

The CCC would like to thank the Chair and Ranking Member for the invitation to submit these recommendations. We would also like to thank Committee Staff for their consideration in this matter. We remain at the Committee's service.

CODIFYING CUSTOMER PRIORITY: SUBORDINATING ALL DEBT TO CUSTOMER CLAIMS

Bankruptcy proceedings surrounding recent FCM insolvencies have involved provisions across disparate legal authorities including: the Bankruptcy Code, the Commodity Exchange Act, and the CFTC's Part 190 Regulations. The complicated and interconnected relationships between these myriad authorities has obscured the original intent of Congress in granting "customers' claims first priority in the distribution of the estate" of bankrupt brokers.[1] As detailed in Senate Report No. 95-989, which accompanied the Bankruptcy Reform act of 1978:

> *A fundamental purpose of these provisions is to ensure that the property entrusted by customers to their brokers will not be subject to the risks of the broker's business and*

[1] Pub. L. 95-598, Senate Report No. 95-989.

will be available for disbursement to customers if the broker becomes bankrupt. As a result of section 765 (enacted as 766[h]), a customer need not trace any funds in order to avoid treatment as a general creditor as was required by the Seventh Circuit in In re Rosenbaum Grain Corporation.[2]

Yet Trustees and courts adjudicating insolvent FCMs have reached differing conclusions. 11 USC § 766 provides "that if a customer is not paid the full amount of such customer's allowed net equity claim from Customer Property, the unpaid portion of such claim is a claim entitled to distribution under section 726 of this title." This has led many to read that customers only have priority to all other claims with respect to the assets held by the debtor in the customer estate. Therefore, customer claims exceeding the value of the customer estate could potentially be treated as unsecured general creditors of debtor's estate property.

The Part 190 Regulations remedy this problem by broadening the definition of what constitutes Customer Property, so as to include FCM estate assets should property recovered for customers be insufficient to satisfy customers' claims. However, one court (in an order later vacated by settlement between parties) found that the CFTC exceeded its statutory authority by broadening the definition of "Customer Property" beyond its definition in Section 761 of Chapter 7 of the Bankruptcy Code. Although the CEA gives the CFTC the authority to determine what constitutes Customer Property (7 USC § 24), the Bankruptcy Code gives a more narrow definition of the term. In the 1999 bankruptcy of FCM Griffin Trading Company, the Northern District Court of Illinois held as follows:

The Court further concludes that the CFTC exceeded its statutory grant of rulemaking authority and that the provisions of 17 C.F.R. § 190.08(a)(1)(ii)(J) are invalid. Pursuant to the provisions of Subchapter IV of Chapter 7 of the Bankruptcy Code, any shortfall in customer property as defined in that Subchapter must be treated as a general unsecured claim.

Although this opinion was vacated, it is possible that another court could reach the same conclusion. There was an open question as to the priority of customers in the MF Global bankruptcy which was avoided by the recently approved liquidation plan in which creditors agreed to make the customer estate whole. There are two ongoing FCM liquidations in which Customer Property shortfalls will persist: Sentinel Management Group ("SMG") and Peregrine Financial Group ("PFGBest"). In either case, customers' claims not satisfied by the Customer Property pool could be treated as general creditor claims. This is clearly contrary to the objective Congress intended to achieve establishing protections for customers of commodity brokers.

Therefore, the CEA needs to be amended to clarify that customers of defunct FCMs have a first priority right over all creditors to estate assets of an insolvent FCM should a shortfall in the customer estate persists. Given that claim priorities are established in the Bankruptcy Code (**11 USC § 507**) and Customer Property maintains a more narrow definition within Chapter 7 (**11 USC § 761 (10)**), the most efficient means to establish a first-priority for customer claims within the framework of the CEA is to create a provision requiring all FCM creditors and affiliates to subordinate their debts and general creditor claims below customer claims.

---

[2] Pub. L. 95-598, Senate Report No. 95-989.

Since the Bankruptcy Code is beyond the purview of this Committee, care should be taken to establish a customer priority congruent with Title 11 provisions. A mechanism that the Bankruptcy Code contemplates which could help achieve this aim, without causing conflicts among statutes, is that of subordination of debt (**11 USC § 510**):

> *A subordination agreement is enforceable in a case under this title to the same extent that such agreement is enforceable under applicable non-bankruptcy law.*[3]

Requiring subordination of non-customer debts and claims with registered FCMs would establish a first-priority right for customers. Further, it would speed distributions of Customer Property by eliminating the need to reserve assets of the customer estate against the claims of a bankrupt FCM's holding company, affiliates or creditors. The SIPA Trustee managing the liquidation of MF Global, Inc. ("MFGI") faced the prospect of protracted litigation with representatives of creditors of MFGI's holding company as well as its affiliated entities. These affiliates entered large claims against MFGI's customer estate. The SIPA Trustee was therefore required to reserve hundreds of millions of dollars in Customer Property against a potential adversarial judgment resulting from these claims, drastically slowing the release of customer funds.

Affiliated entities of bankrupt FCMs should not be permitted to use the claims process as a negotiating ploy designed to pressure a Trustee by stalling distributions of customer funds. If the debt of creditors and affiliates were subordinated, there would be no cause to reserve property for such claims. Additionally, the substantial portions of an FCM's customer estate ensnared in an insolvency proceeding in a foreign jurisdiction would not impact recovery speed if subordination of those claims were the law. This can result in lengthy delays as foreign proceedings play out. Subordinating all debts to customers would free a trustee to use estate assets to make the customer estate whole, regardless of the outstanding claims on them. Moreover, such a subordination provision would benefit customers because large creditors would not be financially rewarded for turning a blind eye to inappropriate or risky FCM business practices. For example, subordination of all business-affiliate debts and claims below customer claims would incentivize large creditors, who often have significantly more insight and control over a FCM's operations than customers do, to perform due diligence on the FCMs internal controls and pay attention to a FCM's potential malfeasance. Significantly, subordination avoids the creation of a 'moral hazard' because it protects the sanctity of customer funds from being manipulated for creditor and/or insider benefit.

---

[3] 11 USC § 510

REQUIRE FCM RESIDUAL FINANCIAL INTEREST IN CUSTOMER SEGREGATED ACCOUNTS TO BE DEPOSITED IN A SEPARATE RELATED ACCOUNT

Although both the CEA and CFR prohibit comingling of FCM and customer funds, 17 CFR 1.23 permits FCMs to maintain a residual financial interest in their customer segregated account in any amount the FCM deems necessary in order to prevent customer accounts from "becoming under-segregated at any time." While this regulation and relevant sections of the CEA create a legal distinction between customer and FCM funds in customer segregated accounts, operationally these funds exist in the same accounts. They are for all practical purposes comingled.

This convenience has given rise to several issues related how an FCM uses and accounts for this residual interest. It gives plausible deniability to those FCMs that would attempt to use customer funds to meet the FCM's own liquidity needs. Plausible deniability arises from the fact that any withdrawal from a customer segregated account could be disguised as a withdrawal from firm excess if the firm provides an accompanying falsified segregation report. However, a more effective buffer could be created in a fashion that completely segregates firm excess and customer funds.

Specifically, firm residual financial interest should be placed in a sub-account linked to the customer segregated accounts so that it may continue to be used as a buffer for customer debits while remaining truly segregated from customer funds. This change in conjunction with the CFTC's recommendation for labeling of customer segregated accounts as such under a modification to Rule 1.20 helps counterparties, such as custodian banks, readily identify the true nature of funds. Had these two rules been in place prior to the collapse of MF Global, both MF Global and JP Morgan executives would have had a much more difficult time justifying the wire and receipt of customer funds, respectively, to satisfy margin calls arising from MF Global's proprietary trading activities.[4]

ESTABLISH SPECIFIC CRIMINAL PENALTIES FOR VIOLATIONS FOR MISAPPROPRIATION OF CUSTOMER FUNDS

Currently, criminal charges for segregation violations rely on federal prosecutors showing criminal intent as part of the conduct of a guilty party. 7 USC § 13 provides that it is a felony punishable by 10 years of imprisonment "to embezzle, steal, purloin or with criminal intent convert" Customer Property. Each of those crimes generally requires an intent to deprive an owner of his property. Requiring a demonstration of criminal intent has allowed bad actors to put forth defenses that their conduct was merely negligent or that they were simply unaware of the actions causing a shortfall in customer segregated accounts. For example, Jon Corzine asserted *"I never intended to break any rules*" in Congressional testimony. [5]

Because the principle of customer account segregation is the most important for protecting marketplace confidence, FCMs must maintain the integrity of the system at all costs. Thus, appropriate public policy to achieve such a goal must seriously deter FCMs from allowing breaches of segregation. The best way to do so is to remove the possibility that FCM executives can escape prosecution by pleading ignorance or negligence and enforce criminal penalties for segregation breaches without the need to prove intent. 7

---

[4] MFGI Trustee's *"First Investigative Report,"* page 23: *http://admin.epiq11.com/MFG/document/GetDocument.aspx?DocumentId=1753875*

[5] *"Corzine Defends Tenure, Puzzles Over Missing Funds,"* http://online.wsj.com/article/SB10001424052970203413304577085953794621344.html

USC § 13 should be amended so there is a strict liability for violations involving the transfer or conversion of Customer Property.

While the CCC would like to see a strict liability standard for infractions involving Customer Property, we do not wish to see those who are trying to comply punished for honest mistakes. Therefore there should be a standard of scale to ensure that violations which arise from honest mistakes are not criminally punished. In cases where there is a shortfall of Customer Property exceeds a firms excess net capital, there should be defined, criminal penalties should for any staff of an FCM who knew or should have known of the improper transfer of Customer Property, or those of any counterparty who receives such improperly transferred Customer Property.

INCREASE SEVERITY OF CIVIL MONETARY PENALTIES FOR SEGREGATION VIOLATIONS

Several major industry participants have violated segregation requirements and faced relatively minor penalties.

- See "*CFTC Sanctions J.P. Morgan Futures, Inc. $300,000 for Failing to Properly Segregate Customer Funds and Failing to Timely Report the Under-segregation to the CFTC*," http://www.cftc.gov/PressRoom/PressReleases/pr5713-09;
- "*Cantor Fitzgerald Sanctioned $700,000 for Allowing Customer Funds to Become Under-Segregated*," http://www.cftc.gov/PressRoom/PressReleases/pr6419-12;
- "*CFTC Orders Connecticut-based Interactive Brokers LLC, a Registered Futures Commission Merchant, to Pay a $225,000 Civil Monetary Penalty,*" http://www.cftc.gov/PressRoom/PressReleases/pr6560-13.

While the size of these fines seems large out of the context of a large financial institution, they are rounding errors when compared to the overall business activities of these firms, and their method of calculation seems to be almost completely arbitrary and inconsistent. When compared to each firm's Adjusted Net Capital as reported by the National Futures Association, it is clear that the fines are minuscule and do not serve as meaningful deterrents.

Firm Name	Adjusted Net Capital as of 2/28/2013	Fine Amount	Fine as % of ANC
JP Morgan	$13,063,109,297	$300,000	0.0023%
Cantor Fitzgerald	$228,216,093	$700,000	0.3067%
Interactive Brokers	$1,668,535,129	$250,000	0.0150%

Thus, rather than act as a deterrent, these fines are a minor cost of doing business which perversely creates an incentive for firms to maintain weak internal controls (and strong legal teams). In fact, many firms use rudimentary, manual Microsoft Excel spreadsheets to track their most important accounting functions,[6] and simply spend massive amounts on litigation to defend their conduct rather than investing

[6] *See "Solutions To Spreadsheet Risk Post JPM's London Whale,"* http://www.forbes.com/sites/tomgroenfeldt/2013/02/19/solutions-to-spreadsheet-risk-post-jpms-london-whale/

in infrastructure. “JPMorgan Chase noted in its annual report filed with regulators that it and its subsidiaries "are defendants or putative defendants in more than 10,000 legal proceedings, in the form of regulatory/government investigations as well as private, civil litigations."[7]

Furthermore, industry-wide practices indicate either a pervasive, cavalier attitude towards maintaining segregation or they reveal that the segregation rules are too difficult to follow. Cantor and Interactive Brokers were supposedly unaware that breaches had occurred for substantial lengths of time before finally self-reporting the violations. Also, the National Futures Association presided over multiple audits of PFGBest, Sentinel, and Interactive Brokers and did not identify a lapse in segregation in any of those three entities. How can we tell customers that their assets are protected if those charged with protecting their funds don’t have the proper internal controls or audit procedures to even ascertain whether or not the funds are segregated?

Alternatively, a failure to segregate should be penalized by the greater of a $250,000 penalty, or 1% of adjusted net capital. Moreover, the CEA should be expanded to specifically convey personal responsibility to the principals of the FCM so that they may not escape punishment due to the insolvency of an FCM. Also, rather than such penalties being paid to the US Treasury, they should be distributed to customers until any shortfall in customer segregated accounts is cured.

ESTABLISH A STATUTORY PROVISION FOR A CUSTOMER COMMITTEE FOR DEBTOR FCMs

JPMorgan and Bank of America are two of the largest financial institutions in the US. While customers of MF Global and PFGBest had to scrape together donated funds and organize intermediaries like the CCC to represent them to the Court, two of the largest banks in the US were able to pay for their legal expenses relating to MF Global from the assets of their holding company's estate. As members of the Creditors' Committee, they can maximize the return to unsecured creditors at little or no expense to them. Customers of FCMs with parent companies in Chapter 11 proceedings should have a statutory right to form a Customers' Committee of the bankrupt parent, with similar rights as the Creditors' Committee. This will ensure that customers are afforded adequate legal representation without additional costs. Each customer account class identified in the CEA and CFR should receive proportional representation to the amount of assets their account class represents of the customer estate.

[7] *See “JPMorgan sees $4.5 billion legal hit,”* http://finance.fortune.cnn.com/2011/02/28/jpmorgan-sees-4-5-billion-legal-hit/

ESTABLISH A SEPARATE ACCOUNT CLASS FOR RETAIL FOREX CUSTOMERS

17 CFR 190.08 establishes that property held for the account of a customer segregated to a specific account class must be must be "allocated to the customer estate of the account class for which it is segregated or to which it is readily traceable". So within the customer estate, various account classes are owed property that can be traced directly to an account class. The CFR establishes the following account classes within the customer estate (17 CFR 190.01(a)), some of which derive their definition from the CEA:

- futures accounts, (7 USC § 6d) commonly referred to as Segregated Funds or 4d funds
- foreign futures accounts (17 CFR 30.7), commonly referred to as 30.7 or Secured Funds
- leverage accounts
- commodity option accounts
- delivery accounts (17 CFR 109.05 (a)(2))
- cleared OTC derivatives accounts

Many FCMs facilitate retail foreign exchange transactions ("retail forex") for customers. These transactions are non-exchange cleared over-the-counter ("OTC") transactions in which the FCM acts as counterparty to a retail forex trader's position. There are substantial differences between these transactions and exchange cleared futures and options trading, so much so that the NFA and CFTC have decided not to expand the entire regime governing futures trading to retail forex trading. As a result, customers who tender property to FCMs to engage in retail forex transactions may not be treated as a separate account class in FCM bankruptcies and they are not offered much in the way of collateral protections in the CFR or CEA. This means they could be treated as general creditors and their property distributed pro rata to other general creditors.

The insolvency of PFGBest demonstrates the need for retail forex customers to be given their own account class. Over $40 million of readily identifiable property of PFGBest's retail forex customers could be distributed pro rata to commodity customers as estate property or split amongst general creditors of the estate. In order to prevent these customers from losing their property in an inequitable distribution, the Committee should consider revising the CEA accordingly.

ESTABLISH A SEPARATE ACCOUNT CLASS FOR ALTERNATIVE SEGREGATION ARRANGEMENTS

Industry participants have begun testing alternative segregation arrangements in which Customer Property is held outside the control of an FCM. These arrangements typically involve another party acting as trustee for customer funds, such as a custodial bank. The bank manages the variation margin payment and collection between the exchange and customer account, while the FCM acts as a trade processor. Several models are currently being tested throughout the world, ranging from tri-party and quad-party models designed for swaps markets to direct customer accounts at exchanges.

While alternative segregation arrangements do provide end users with the comfort of having the FCM removed from direct access to their funds, these arrangements are merely 'bankruptcy-remote', in that they are still subject to a pro rata distribution of a shortfall if an FCM defaults. Making these arrangements 'bankruptcy-proof' may require changes to the Bankruptcy Code, but revisions to the CEA can help limit the extent to which a bankruptcy Trustee can pursue and distribute such Customer Property maintained in such arrangements.

The CEA should be amended so that alternative segregation arrangements are given their own separate account class status. This would limit the amount of Customer Property put at risk due in the event of an FCM insolvency in which there was a shortfall in Customer Property. While this would not clear these customers of fellow customer risk within their own account class, it would go a long way toward eliminating FCM malfeasance risk.

GIVE THE CFTC AUTHORITY TO DETERMINE THE APPROPRIATE LIQUIDATION PROCEEDING FOR INSOLVENT FCMs

Modern FCMs can have complicated corporate structures and many are dually registered as broker-dealers. As a result, there is confusion at the outset of an FCM default as to which statute will govern the broker liquidation. MF Global went through a SIPA Liquidation, despite the fact that its revenue was overwhelmingly derived from its FCM business line (38,000 commodity accounts compared to 200 securities accounts).

The CFTC is best positioned to determine the appropriate bankruptcy course for FCMs. The Committee should consider revising the CEA to give the CFTC authority to make that determination for any registered FCM.

EXAMINE WHETHER OR NOT THE CEA REQUIRES AN AMENDMENT TO PERMIT THE NFA TO RAISE ASSETS FOR AN INSURANCE FUND FROM ITS MEMBER ASSESSMENTS

As the Committee may be aware, the NFA is conducting a study regarding several types of customer account insurance. Although it may or may not be appropriate for the NFA to assume such a responsibility, the CCC believes that the NFA should be free to examine providing such a fund from fees and assessments it already raises from its membership. While we cannot find any provision of the CEA which would prevent NFA from using its member assessments to pay for a customer protection scheme or insurance fund, NFA President Daniel Roth testified before the Committee that a change in the statute is required:

> *With respect to a fee generated through NFA to cover the cost of the insurance, I would just point out as a technical matter that would require an amendment to the statue because under the existing law there are very strict limits on what we can use our fees and assessments for. They can only be used to defray reasonable administrative expenses.*[8]

Given Mr. Roth's testimony, we would like the Committee to consider what aspects of the CEA need to be revised to remove restrictions on the NFA's fees and assessments for the purposes of funding a customer protection fund or account insurance mechanism. The NFA should be free to determine

---

[8] Committee on Agriculture, Nutrition & Forestry. *Hearing: Examining the Futures Markets: Responding to the Failures of MF Global and Peregrine Financial Group*.

whether or not such a protection fund is consistent with its mission and resources, rather than have it precluded by limitations on its fee structure in the CEA or CFR.

GIVE THE CFTC AUTHORITY TO BRING CRIMINAL PROSECUTIONS

CFTC Commissioner Bart Chilton stated that as of February 2009, "DoJ initiated criminal action in only 65 of the 173 cases referred to it by the CFTC over the past five years.[9]" Considering that the majority of bad actors whom the CFTC, with its far greater level of commodity-related expertise, thinks should be in jail never face charges, there certainly is a great deal of slack to be taken up. Who would be better to do so than the CFTC, the agency with the pertinent expertise in a highly technical field?

Giving the CFTC the right/obligation to bring criminal charges would increase the budget required by the agency. This cost could be funded by repurposing the portion of the DoJ's budget assigned for commodity enforcement to the CFTC. Additionally, the CFTC could be allowed to keep all or a portion of the penalties it collects as a part of civil and criminal enforcements for use towards its operating needs. This would incentivize the agency to maximize the penalties it agrees to as part of settlement agreements and to be successful in prosecution of enforcement actions.

---

[9] "*CFTC's Chilton seeks criminal authority to fight market fraud*" http://www.agri-pulse.com/uploaded/20090227H.pdf