National Grain and Feed Association

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TESTIMONY OF THE

NATIONAL GRAIN AND FEED ASSOCIATION

TO THE COMMITTEE ON AGRICULTURE, NUTRITION AND FORESTRY

UNITED STATES SENATE

JULY 17, 2013

Good afternoon, Chairwoman Stabenow, Ranking Member Cochran, and members of the committee. I am John Heck, Senior Vice President of The Scoular Company in Omaha, Nebraska. The Scoular Company, founded in 1892, manages commodity supply-chain risk for customers in food, feed and renewable fuel markets. From more than 70 locations across North America, nearly 700 Scoular employees tailor risk-management solutions for their customers by buying, selling, storing and transporting grain and ingredients.

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 committee 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.

The CFTC currently is evaluating comments submitted with regard to this proposed rule, issued November 14, 2012, that seeks to bolster futures customer protections – a laudable goal. However, two very troublesome provisions in the proposed rule would have the perverse effect of 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.

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>Reforms to the U.S. Bankruptcy Code</u>

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 89% of their funds – funds that were supposed to have been segregated and protected. Recent developments have made it increasingly likely that the remaining 11% 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 two years after the fact, former customers of MF Global have received back only 89% of their supposedly safe segregated funds through distributions from the trustee. 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.