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STATEMENT OF JOHN L. ROE
BEFORE THE UNITED STATES SENATE
COMMITTEE ON AGRICULTURE, NUTRITION AND FORESTRY
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Good morning Chairwoman Stabenow, ranking member Roberts and members of the Committee. Thank you for the invitation to appear before you today to discuss the Commodity Customer Coalition's recommendations for the policy response to the MF Global bankruptcy, as well as the recent insolvency of PFGBest. It has become a very risky proposition to tender one's property to a commodity broker. An industry which just a year ago prided itself that no customer had ever lost a penny as the result of a clearing member default now hopes customer losses due to broker insolvencies will be limited to hundreds of millions of dollars, instead of billions of dollars.

Whatever the motives for recent breaches in the segregation protections, simple schemes subverted hundreds of regulators and auditors tasked with monitoring customer property at commodity brokers. The system of commodity regulation is broken. In fact, the system which regulates non-clearing FCMs is so broken that the regulator in charge of auditing PFGBest's financials could not tell that the fines levied against PFGBest were being paid to regulators with customer money--$700,000 this year alone.[1]

Before this Committee, CFTC Chairman Gensler testified that, just as it is unreasonable to expect police to stop all bank robbers, it is unreasonable to expect commodity regulators to stop all fraud. Yet, bank customers do not live in fear that their deposits will be robbed by the bank. Moreover, in the event that a bank theft is so large that it causes the bank to become insolvent, bank customers have insurance to protect their deposits. Should Chairman Gensler's robbers hold up a broker-dealer, their customers are also afforded insurance to protect their cash and securities. Commodity customers are only protected by the regulators and the Commodity Exchange Act, the relevant portions of which were passed when the industry was about 2% of its present size. [2]

There is no mechanism in place outside of the bankruptcy process to deal with shortfalls in customer property. Once customer accounts are attached to an FCM bankruptcy, the potential for losses to customer property has only begun. In addition to whatever assets with which the broker has absconded, customers face losses stemming from their inability to manage frozen trading positions and collateral. In the first bulk transfer of customer property ordered by the SIPA Trustee for MF Global customers, 10,000 margin calls were issued which had to be cleared on the same business day. As a result, millions of positions were liquidated. Customers holding positions on foreign boards of trade had their positions held for much longer periods and were unable to manage their risk associated with these positions.

Customers then face a bankruptcy process with fees in excess of $200 an hour for paralegals, $450 an hour for inexperienced attorneys and law firm partners billing nearly $1,000 an hour. The firms submitting these bills have the audacity to claim their rates have been discounted in the public interest. The market price for these services is anywhere from 30% to 70% less than the rates in the applications for fees we see in recent court filings. The bankruptcies of MF

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[1] NFA fined PFGBest in February 2012: http://goo.gl/NrpOL. If PFGBest had a deficit in segregation at that time, then this money belonged to PFGBest customers.

[2] Bankruptcy provisions of the Commodity Exchange Act were amended in 1978, a year in which the Futures Industry Association reports 58 million contracts trading in the US. in 2011, over 3 billion contracts traded in the US.

Global and PFGBest will drag on for years, the administrative fees will run into the hundreds of millions of dollars and if there is not enough estate property to cover these fees, customer losses will be compounded.

Participants in American financial markets deserve better. They deserve the strongest, most efficient legal protections available. They deserve a safety net when regulators fail. We have to stop expecting the regulators to do their jobs and start offering customers protections when they do not. If Mr. Gensler's robbers cannot be stopped then at a minimum they must be insured against.

AN FCM LIQUIDITY FACILITY

Among the policy recommendations that the Commodity Customer Coalition has proposed to mitigate future FCM insolvencies[3], the most important is an account insurance mechanism. We propose an industry-funded liquidity facility, which focuses on providing liquidity to plug shortfalls in customer property and ensure accounts are quickly transferred to new brokers with positions intact. The fast transfer of customer accounts is critical to clearing the customers from the machinations of bankruptcy proceedings. This fund would then step into the shoes of customers who would have been in the bankruptcy. It would pursue recoveries for the fund's liquidity disbursement to facilitate the transfer of customer accounts and reserve property against claims made against customer property by counterparties.

This liquidity facility would not be government funded or managed and it would be designed to shield taxpayers from the burden of FCM insolvency. Assets for the fund could be raised transactionally, as well as through member firm assessments. Last year, a one penny per contract fee--half of the transaction fee assessed per contract by the NFA--would have raised over $30 million for such a fund. Such cash flow would grow to substantial resources in little time and provide collateral for loans to cover insolvencies in the immediate term.

There is a working model of this type of fund in Canadian markets. Both PFGBest and MF Global had Canadian subsidiaries. The insolvency of these Canadian affiliates is expected to result in no losses for Canadian customers. MF Global's Canadian subsidiary held about $385 million in customer property, an amount roughly equivalent to the customer property held by PFGBest[4]. Some 7,800 customer accounts of MF Global Canada were transferred with 100% of their property to a new broker within two weeks of the insolvency. This transfer was facilitated by the Canadian Investor Protection Fund which provided MF Global Canada's Bankruptcy Trustee with a 20% guarantee of the assets of MF Global Canada's customer property. This guarantee plugged a 20% shortfall in assets and facilitated the immediate transfer of customer property. The only reason it took two weeks to process this transfer was due to the SIPA Trustee's mistaken transfer of assets residing in Canadian customer accounts in the US. These assets had to be transferred back to Canadian control, which delayed the broker transfer.

The Canadian Investor Protection Fund has reserved its own capital in the event ongoing litigation between the US and Canadian entities of MF Global is resolved to the detriment of the Canadian estate. Whether or not it is, Canada's commodity customers can still make the claim that no customer has ever lost a penny as the result of a clearing member default.

Like all types of insurance, there must be some coverage limits for a US-based FCM liquidity facility. The Canadian Investor Protection Fund covers up to $1 million per customer of a shortfall in their property. If such limits were applied to a US insurance mechanism managing MF Global's insolvency, only accounts with more than $5 million in assets would

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[3] For a complete description of all CCC recommendations, please see our proposal entitled: *Recommendations on the Policy Response to the MF Global Bankruptcy*. http://goo.gl/L4AJQ.
[4] From the CIPF 2011 Annual Report: http://goo.gl/tlPGc

be at risk of sustaining a loss.[5] Additional limits could include classes of customer property--segregated funds (regulation 4d), secured funds (regulation 30.7 funds) or specifically identifiable property--or an opt-in mechanism could be employed to exclude participants who do not wish to be covered.

If the FDIC can insure $4.3 trillion in bank deposits with a reserve ratio which has fluctuated between 1.22% and 0.27%, surely the commodities industry can insure the $190 billion or so in segregation with a similar reserve ratio of exposure to insured accounts.

SPECIFIC CRIMINAL PENALTIES FOR MISUSE OF CUSTOMER FUNDS

While the PFGBest case will most certainly result in criminal convictions for perpetrators of its fraud, the probability of a criminal conviction in the MF Global case is less certain. The lesson of MF Global should not be that there are no criminal consequences for swiping customer funds for the proprietary benefit of a broker. Should prosecutors not seek charges in connection with MF Global's insolvency, Congress must enact specific criminal penalties to punish the misuse of customer property at FCMs. While no law can deter the raw greed of a PFGBest-like scheme, strict criminal penalties can deter firms which might be willing to use customer funds for proprietary purposes in the absence of them. It is doubtful that executives or their subordinates will be willing to risk incarceration for misusing customer property.

MEASURES TO DIFFUSE THE RISK OF DUALLY REGISTERED BROKER-DEALERS

One of the most obvious differences between the PFGBest and MF Global bankruptcies is that PFGBest's liquidation is being conducted under the Chapter 7 provisions of the Bankruptcy Code as opposed to the SIPA statute. MF Global's broker-dealer and FCM operations were combined in a single corporate entity and, as a SIPC member, SIPC petitioned the Court for a SIPA liquidation of MF Global. PFGBest did have a SIPC-member broker-dealer affiliate, but its operation was held in a separate legal entity from PFGBest's FCM operation.

The combination of broker-dealer and FCMs into a single corporate entity carries with it several risks. One is that, at the outset of an insolvency of such a firm, the application of SIPA will cause tremendous confusion as to customer priorities. At a minimum, this results in more pleadings and a slower track for the bankruptcy proceeding. Additionally, securities customers are less sensitive than commodity customers to the administrative costs of a SIPA liquidation as they are afforded account insurance. In this sense, it was possible for the 200 or so securities accounts (which contained only around $400 million) to prime the 38,000 commodity customer accounts holding over $6 billion in assets in MF Global's SIPA Liquidation. SIPA's claims process is much slower and affords far less discretion to the Trustee than the Chapter 7 and CEA provisions which typically govern commodity broker bankruptcies.

Another risk of joint broker-dealer FCMs is illustrated by the recent fine levied against JPMorgan for its unlawful handling of Lehman's customer segregated funds. JPMorgan extended credit to Lehman for its own proprietary trading based on the value of customer segregated balances held by Lehman at JPMorgan. After Lehman's failure, JPMorgan attempted to withhold those funds. The CFTC fined JPMorgan $20 million for the unlawful handling of these funds. As was the case with MF Global, Lehman's illiquid broker-dealer operation sought the use of commodity customer collateral for proprietary purposes.

There is a tremendous concentration risk associated with joint broker-dealer FCMs, as 80% of customer segregated property in the US resides in just 10 firms. 9 of these 10 firms were recipients of over $11 trillion in assistance from the

[5] The account class of regulation 4d customers of MF Global, Inc, whose collateral was margining positions on US exchanges, has received 80% of that property from the SIPA Trustee. If insurance covered up to $1 million of a shortfall, then losses would only be incurred by accounts with more than $5 million in assets. Regulation 30.7 customers, who have received less than 10% of the portion of their account held as 'secured funds', would be exposed to losses at a lower threshold.

Federal Reserve Bank during the 2008-2009 financial crisis. In fact, over $35 billion in commodity customer property has been exposed to insolvency at broker-dealer FCMs since the financial crisis.[6] Most of these firms are systemically important investment banks, which means that their comingled FCM operations should give regulators pause.

The Commodity Customer Coalition urges Congress to consider forcing broker-dealers and FCMs to split their operations into separate legal entities. This will ensure that insolvent FCM entities enter Chapter 7 liquidations while insolvent broker-dealers undergo SIPA liquidations. Forcing this separation will also reduce the potential for illiquid broker-dealer operations to borrow from commodity customer property. It will also limit the concentration risk associated with broker-dealer FCMs by ensuring that insolvencies are contained within specific entities. If forcing the legal separation of broker-dealer FCM entities is beyond the pale, then at a minimum the unencumbered collateral of commodity customers with accounts at broker-dealer FCMs should be covered by SIPC.

BANKRUPTCY REFORM

Specific reforms to the Bankruptcy Code may be outside the purview of this Committee, but such reforms are an important component of a complete policy response to recent FCM insolvencies. Those reforms should include the prevention of the automatic application of the Safe Harbor provision of the Bankruptcy Code. Simply put, the law should not allow the recipients of stolen property the means by which to keep it. Market pricing or fee limits should be introduced for the administration of bankruptcy cases. Additionally, there should be a statutory provision for customers to sit on the Creditors Committee of a bankrupt FCM's parent company in a Chapter 11 proceeding. This will help defray the legal costs associated with bankruptcies which follow the same tack as MF Global. Finally, affiliate and parent firms of insolvent FCMs should be forced by law to subordinate their claims in bankruptcy to commodity customer claims. This will increase the speed at which future Trustees of bankrupt brokers can make distributions to customers.

CONCLUSION

Some in the industry will argue that substantive changes have already been made to commodity regulations. They will argue that these changes are sufficient to diminish the likelihood of future frauds and will serve to assuage the probability of future insolvencies involving shortfalls in customer property. They will point to the NFA's recent requirement for electronic bank statements and the abolition of the alternative method for the calculation of secured funds as evidence of this. They will say that we do not need costly new regulatory regimes, we simply need to enforce what is on the books.

However, this logic assumes that thieves lack ingenuity. It assumes that the same technological advances used by the regulators will not also aid the thieves themselves. History demonstrates that regulators are the last to adopt new technologies. No more poignant evidence of this is that, in 2012, regulators were still relying on paper statements requested from a Post Office box in Cedar Rapids, Iowa.

If we are to protect ourselves from Chairman Gensler's robbers, the industry is going to have to do a little better than that. We urge Congress to act to protect commodity customers when and where the industry does not.

[6] MF Global and Lehman, along with firms that would have gone bankrupt without intervention (Bear Stearns and Merrill Lynch), held over $35 billion in segregated customer property.