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TESTIMONY OF JAMES L. KOUTOULAS
PRESIDENT AND CO-FOUNDER
COMMODITY CUSTOMER COALITION

BEFORE THE COMMITTEE ON AGRICULTURE OF THE
UNITED STATES HOUSE OF REPRESENTATIVES

October 2, 2013

Chairman Conaway, Ranking Member Scott, Members of the Committee, thank you for the opportunity to testify at this important hearing. My name is James Koutoulas and I am the President and Co-Founder of the Commodity Customer Coalition. While I also serve on the Board of Directors of the National Futures Association, my testimony does not necessarily represent the views of that organization.

While I am deeply honored that our organization was invited to testify before this committee before the two year anniversary of our creation, the fact that we exist at all is evident of the need to improve protections for commodity customers. For those unfamiliar with us, a lot of things had to go wrong for the CCC to be formed.

Industry Failures Results in the Formation of the CCC

With MF Global teetering on the brink of bankruptcy, its DSRO, CME Group, had grave concerns about the sanctity of segregated accounts and, four days before the bankruptcy, instructed MF Global management that no transfers were permitted without CME's express written consent. However, CME Group did not take the extra step of enforcing that instruction by requiring CME approval for wire transfers initiated via MF Global's treasury software, JP Morgan Access, something that would have only taken a few minutes to configure. This oversight allowed MF Global staff to transfer customer funds to meet house margin calls at JP Morgan, creating a shortfall of over $1 billion dollars according to the MFGI trustee's *MF Global Investigation Report*. This occurred despite the fact that, per the trustee's report, JP Morgan's Chief Risk Officer personally informed MF Global management that they thought customer funds were at risk. JP Morgan sent MF Global management three variants of a comfort letter asking them to certify that no customer funds were transferred, and, although none of the three letters were signed and returned by MF Global management, JP Morgan did not return these customer assets for over 18 months after the bankruptcy.

Once MF Global filed for bankruptcy, its counsel represented that there was no shortfall in customer accounts, despite internal communication by MF Global senior management to the contrary. On that basis, the bankruptcy judge permitted MF Global Holdings to enter Chapter 11 rather than Chapter 7, and appointed an additional trustee to oversee that "reorganization." The appointed trustee permitted MF Global senior management to remain at the firm, even while over a billion dollars in customer money was still unaccounted for, and even went so far to claim attorney-client privilege on their behalf in his dealings with criminal investigators. This transpired in conjunction with the SIPA trustee's alarming initial plan to keep MF Global customers' cash frozen for a full nine months, and then allow the release of only 60% of the funds.

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In the face of this long list of obstacles delaying the return of their property, thousands of customers reached out to John Roe and myself after we received early media attention for our efforts to expedite the return of our own customers' property. After hearing stories of farmers incapable of buying seed, retirees unable to withdraw their savings to buy medicine, and a single mother who was in danger of losing her home, John and I organized the CCC and each contributed thousands of hours of pro bono service to help expedite the return of the property throughout the estate.

Outcomes for MF Global Customers

Thankfully, our advocacy and litigation efforts, helped by the indemnity that CME provided to the trustee, all customers received 72% of their property back that was in 4(d) designated accounts seven-and-a-half months ahead of the trustee's initial plan—although 30.7 customers had no such luck and only received a majority of their funds back 20 months after the bankruptcy. Now, thanks to the CFTC's proposed settlement with MF Global, Inc., all customers are expected to receive 100% of their property back roughly two years after the bankruptcy. While this outcome exceeds almost all of the expectations formed upon the realization that there was a shortfall of over a billion dollars in customer accounts, it is simply unacceptable that customers were deprived of their property for even one day. Worse still, they felt they had little choice other than to rely on a handful of volunteers, with no bankruptcy or litigation experience, to represent them against the country's biggest bank and a former FBI director.

After MF Global's collapse, the industry has shown a renewed vigor towards protecting customer funds, and has implemented many thoughtful reforms, such as those delineated by Mr. Roth, namely: the "MF Global Rule," more stringent standards for FCM internal controls, and the daily electronic confirmation of segregated account balances. Nevertheless, in the less than two years since MF Global's bankruptcies, eight FCMs have already been fined for failing to comply with various segregation regulations, PFGBest's transgressions the most grave amongst them.

Industry Failures Continue

PFGBest's customers have fared far worse than MF Global customers. Despite entrusting their funds to segregated accounts held by a regulated entity that was audited annually by a SRO, last summer their customers were told that over $200 million of assets had been stolen over 20 years. At this time, their only hope to recover more than 50% of their property is for the CFTC to prevail in its litigation against US Bank, which allegedly allowed PFGBest to treat its segregated accounts as if they were commercial checking accounts.

Strengthening Protections through Bankruptcy Reform and Insurance

While both governmental and private regulators have generally done a good job protecting customers historically, everyone makes mistakes. Unfortunately, customers have bared almost all of the consequences of both debacles, as no regulator has lost their job, JP Morgan has not faced an enforcement action for knowingly receiving customer funds, and no member of MF Global management has been charged with a crime or been investigated for the many potential misrepresentations they may have made before this, and other congressional committees. Thus, sole responsibility for the safety of customer property currently relies on a combination of public and private entities, none of whom have skin in the game, to maintain segregation at all times, which they have repeatedly failed to do.

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Despite declining to enforce many of the existing regulations we already have on the books, the CFTC has now proposed over 500 pages of new rules, some of which we think add real value to customer protections, such as the expanded testing of FCM internal controls, the implementation of improved risk management procedures, and the required filing of certified FCM annual reports. Unfortunately, these proposed new rules also contain the most onerous burden ever placed on customers: the new residual interest rules.

The Proposed Changes to Residual Interest Do More Harm Than Good

These rules would require customers whose faith in the segregated account system has been badly shaken by the failures of MF Global and PFGBest to double down on it, by almost literally requiring twice the amount of cash that is currently held in segregation industry-wide. The would-be Russ Wassendorfs of the world do not need access to more cash from farmers, ranchers, and investors should they wish to engage in future malfeasance. Moreover, the businesses of small-to-midsize agricultural users and traders have been severely strained over the last several years due to the difficulties of making money in a persistent zero interest rate environment and the loss of customer confidence due to the MF Global and PFGBest insolvencies. Requiring the industry to comply with hundreds of pages of new rules while also tying up additional capital could very well be the final straw that puts many out of business.

Instead of implementing many of these new rules, especially the proposed residual interest change, the industry as a whole would be better protected by consistently enforcing the existing. With respect to criminal penalties, I would like to remind the committee that any willful violation of the Commodity Exchange Act is a felony punishable by 10 years in prison. There are least a few cases where this law should have been enforced, but as of now, justice has yet to be pursued. On the civil side, penalties have generally been assessed in relatively fixed amounts, giving the regulatory regime the worst of both worlds—devastating small firms while failing to provide a meaningful deterrent to large firms.

It is Time to Finally Fix *Griffin Trading* and Restore Customer Priority

That is not to say some additional rule changes are not necessary. A few pages of legislative language would go a long way towards preventing future commodity customers from waiting years to receive the return of their property should another FCM go bankrupt with a shortfall in customer funds. In 1999, a small FCM named Griffin Trading was in such a situation. In *Griffin,* customers wound up recovering all of their property after an eventual settlement. Before that happened, a District Court judge held that the CFTC overstepped its authority by regulating that customers had priority over assets needed to fill a shortfall in segregated accounts. While this ruling was vacated by the settlement, it has still been cited as precedent for denying customers the immediate return of their property. **The industry has been well aware of the weakening of customer protections caused by *Griffin* for 14 years. Nevertheless, it did not make an effort to address it as part of the 2005 revisions to the Bankruptcy Code, which would have mitigated much of the suffering of Sentinel, MF Global, and PFGBest customers, and reduced the massive fees charged to those respective estates by bankruptcy trustees.**

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Restoring Customer Priority Through Subordination

It is time that we address this long-neglected issue and take this opportunity to modify the CEA to require FCMs to subordinate the claims of their affiliates and lending institutions to customer claims in the event of a shortfall in segregated accounts. This would allow future bankruptcy trustees to return funds to customers much more quickly, as they would not have to reserve and wrangle over dubious claims of preference made on customer assets. Some members of the industry complain this change would be burdensome for FCMs seeking funding; however, this provision would simply return the operation of the law to the way it was written in 1974.

Strengthen Customer Priority by Giving Proper Statutory Authority to CFTC

In addition to enacting this subordination provision, the CFTC's current regulation Section 190.08(a)(i)(J) should simply be codified in the CEA directly to invalidate the authority argument made by *Griffin's* judge. The regulation states that "customer property" includes … "cash, securities or other property of the debtor's estate, including the debtor's trading or operating accounts and commodities of the debtor held in inventory, but only to the extent that the property enumerated [above] is insufficient to satisfy in full all claims of public customers." Codifying that regulation in conjunction with enacting a subordination provision would leave no doubt as to the priority of customer funds in a bankruptcy without opening up the bankruptcy code, which we have been told is akin to a zombie apocalypse.

Customer Account Insurance

In testimony before the Senate Committee on Agricultural, Nutrition, and Forestry, the CCC advocated for the creation of a private insurance mechanism to cover FCM malfeasance before the uncovering of the PFGBest fraud. We agree with our colleagues here that insurance for commodity accounts is a complicated matter which requires deliberative study. The type of insurance as well as its triggers and limits are just a few of the nuances which will drastically affect the costs and benefits of such insurance; however, you do not need a study to determine that there is a type of customer who would benefit from an insurance mechanism. As MFGI Trustee Giddens noted in his *MF Global Investigation Report*, 78% of MF Global customers could have been fully insured with a $200 million fund. That amount seems to be a much easier sum to raise than the billions required by the CFTC's Residual Interest proposal. Indeed, 91.5% of commodity customers surveyed by the CCC are in favor of some type of an insurance mechanism.

Ring-fencing New Account Classes

Finally, the addition of new, segregated account classes for retail FX customers and for safekeeping accounts is a simple legislative change that would improve customer protections for groups that are often neglected. Many in the industry view FX customers as the red-headed stepchildren of the futures regulatory regime, and argue that they do not deserve the protections of segregation if they do not trade exchange-cleared products. We beg to differ, though, and if the futures industry is responsible for regulating retail FX, it should not expect retail customers, most of whom are also futures customers, to understand that nuanced argument. Rather, it should do its best to protect all customers by giving them segregation protections, so they do not end up as general creditors like PFGBest customers probably will, even though no theft occurred in the FX accounts there.

There has also been significant demand for safekeeping accounts, especially from mutual funds, which would allow customers to hold their excess margin in an individually-segregated account at a custodial bank rather than in a commingled segregated account at a FCM. Currently, CFTC Interpretation 10 essentially prohibits

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that practice, stating that such an account would still suffer a pro rata loss during a FCM bankruptcy for which there was a shortfall in the general segregated pool. We recommend creating a separate account class for safekeeping accounts and repealing Interpretation 10 to make the implementation of such an account class viable.

Thank you again Chairman Conaway, Ranking Member Scott and Members of the Committee for inviting us here today. We are honored to be included in these important discussions as to how best protect commodity customers going forward.

Committee on Agriculture
U.S. House of Representatives
Information Required From Nongovernmental Witnesses

House rules require nongovernmental witnesses to provide their resume or biographical sketch prior to testifying. If you do not have a resume or biographical sketch available, please complete this form.

1. Name:_____James L. Koutoulas, Esq._____

2. Organization you represent: ___Commodity Customer Coalition, Inc._____

3. Please list any occupational, employment, or work-related experience you have which add to your qualification to provide testimony before the Committee: ____
____CEO of Typhon Capital Management- a Commodity Trading Advisor and Commodity Pool Operator; Pro Bono Bankruptcy Counsel for over 10,000 MF Global and PFG Customers; President and Co-Founder of the Commodity Customer Coalition; Member of the Board of Directors and Executive Committee of the National Futures Association; Member of Board of Advisors of the Northwestern University School of Law Investor Protection Clinic

4. Please list any special training, education, or professional experience you have which add to your qualifications to provide testimony before the Committee: Securities Law Concentration at Northwestern Law, Series 3 Commodity Brokerage License

5. If you are appearing on behalf of an organization, please list the capacity in which you are representing that organization, including any offices or elected positions you hold: President and Co-Founder _____
_____
_____

PLEASE ATTACH THIS FORM OR YOUR BIOGRAPHY TO EACH COPY OF TESTIMONY.

Committee on Agriculture
U.S. House of Representatives
Required Witness Disclosure Form

House Rules* require nongovernmental witnesses to disclose the amount and source of Federal grants received since October 1, 2010.

Name: ____James L. Koutoulas, Esq._____

Organization you represent (if any): __Commodity Customer Coalition, Inc._____

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1. Please list any federal grants or contracts (including subgrants and subcontracts) <u>you</u> have received since October 1, 2010, as well as the source and the amount of each grant or contract. House Rules do <u>NOT</u> require disclosure of federal payments to individuals, such as Social Security or Medicare benefits, farm program payments, or assistance to agricultural producers:

Source:_____None_____ Amount:_____

Source:_____ Amount:_____

2. If you are appearing on behalf of an organization, please list any federal grants or contracts (including subgrants and subcontracts) <u>the organization</u> has received since October 1, 2010, as well as the source and the amount of each grant or contract:

Source:_____None_____ Amount:_____

Source:_____ Amount:_____

Please check here if this form is NOT applicable to you: _____

Signature:_____

* Rule XI, clause 2(g)(5) of the U.S. House of Representatives provides: *Each committee shall, to the greatest extent practicable, require witnesses who appear before it to submit in advance written statements of proposed testimony and to limit their initial presentations to the committee to brief summaries thereof. In the case of a witness appearing in a nongovernmental capacity, a written statement of proposed testimony shall include a curriculum vitae and a disclosure of the amount and source (by agency and program) of each Federal grant (or subgrant thereof) or contract (or subcontract thereof) received during the current fiscal year or either of the two previous fiscal years by the witness or by any entity represented by the witness.*

PLEASE ATTACH DISCLOSURE FORM TO EACH COPY OF TESTIMONY.