COMMITTEE ON AGRICULTURE, NUTRITION AND FORESTRY

UNITED STATES SENATE

REAUTHORIZATION OF THE COMMODITY FUTURES TRADING COMMISSION

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July 17, 2013

Chairman Stabenow, Ranking Member Cochran and members of the Committee, thank you for the opportunity to provide our perspective on matters affecting the derivatives industry and in particular the regulation of our markets by the Commodity Futures Trading Commission (CFTC). As you turn your attention to reauthorizing the CFTC, the Futures Industry Association (FIA) stands ready to assist in any way we can. FIA is the leading trade organization for the futures, options and over-the-counter cleared derivatives markets. It is the only association representative of all organizations that have an interest in the listed derivatives markets. Its membership includes derivatives clearing firms, traders and exchanges from more than 20 countries. FIA's core constituency consists of futures commission merchants, commonly known as FCMs, and the primary focus of the association is the global use of exchanges, trading systems and clearinghouses for derivatives transactions.

As you know, clearing has long been an integral part of the futures market structure. Clearing ensures that parties to a transaction are protected from a failure by the opposite counterparty to perform their obligations, and the FCMs that FIA represent play a critical role in ensuring that transactions are secured with appropriate margin to facilitate this clearing process.

Improving Customer Protection

I would like to take this opportunity to update the Committee on recent efforts to improve the handling of funds and other collateral that customers deposit with FCMs to margin futures and cleared swaps positions. As you know, the failures of MF Global Inc. and Peregrine Financial Group resulted in severe and unacceptable consequences for futures customers and the

markets generally. The entire industry has been working collaboratively to identify and improve procedures required to better protect the integrity of these markets. A number of changes are being implemented, many of which were recommended by FIA in the aftermath of these insolvencies[1]:

- The National Futures Association (NFA) and the CME Group (CME), the industry's principal self-regulatory organizations, have adopted rules that subject all FCMs to enhanced recordkeeping and reporting obligations. For example, chief financial officers or other appropriate senior officers are now required to authorize in writing and promptly notify the FCM's designated self-regulatory organizations (DSRO) whenever an FCM seeks to withdraw more than 25 percent of its excess funds from the customer segregated account in any day – these are funds deposited by the FCM into customer segregated accounts to guard against customer defaults.

- NFA and CME have launched an automated system for the daily monitoring of all customer segregated, secured, and cleared swaps amounts held by FCMs. As part of this project, NFA and CME contracted with AlphaMetrix360, a subsidiary of AlphaMetrix Group, to aggregate the data on customer segregated, secured, and cleared swaps amount accounts. The new system will allow NFA and CME to run an automated comparison of the balances in customer segregated, secured, and cleared swaps accounts at the depositories with the daily reports they receive from FCMs, and then quickly identify any discrepancies.

- NFA is also collecting additional financial information from FCMs and posting that information on its online Background Affiliation Status Information Center (Basic) system, a key step in giving customers the tools they need to monitor the assets they

[1] See Futures Industry Association, Futures Markets Financial Integrity Task Force - Initial Recommendations for Customer Funds Protection: http://www.futuresindustry.org/downloads/Initial_Recommendations_for_Customer_Funds_Protection.pdf

deposit with their FCMs. The new service provides the public with access to specific information about an FCM, such as the firm's adjusted net capital, the amount of funds held in segregated, secured, and cleared swaps accounts, and the types of investments that the FCM is making with those customer funds.

- NFA has also proposed an interpretive notice that contains specific guidance and identifies the minimum required standards for FCM internal controls such as separation of duties; procedures for complying with customer segregated and secured amount funds requirements; establishing and complying with appropriate risk management and trading practices; restrictions on access to communication and information systems; and monitoring for capital compliance. This notice is in addition to more stringent internal control standards recently developed by the NFA, CME and other self-regulatory organizations.

- A set of frequently asked questions on customer funds protection[2] has also been developed by FIA, which is being used by FCMs to provide their customers with increased disclosure on the scope of how the laws and regulations protect customers in the futures markets.

- Additionally, FIA, CME Group, NFA, and the Institute for Financial Markets have partnered to fund an evaluation of the costs and benefits of various asset protection insurance proposals. We look forward to sharing these findings with the Committee when available in the coming weeks.

In addition to the efforts undertaken by the industry, the CFTC has recently proposed a set of comprehensive regulations to further enhance customer protection. To a significant extent, the

[2] See Protection of Customer Funds, Frequently Asked Questions: http://www.futuresindustry.org/downloads/PCF-FAQs.PDF

proposed rules build upon and codify the recommendations that FIA made and rules that the DSROs have adopted. FIA endorses the regulatory purposes underlying the proposed amendments. We nonetheless submitted an extensive comment letter designed, in substantial part, to assist the Commission in striking an appropriate balance among its several proposals to assure that the producers, processors and commercial market participants that use the derivatives markets to manage risks will be able to continue to have cost-effective access to the markets and a choice of FCMs. In particular, we would like to make the Committee aware that contained within the proposal is a significant modification to the Commission's current interpretation of how customer margin obligations will be determined and when an FCM must calculate each customer's segregation requirement and inject its own resources (commonly referred to as "residual interest") into the customer's account. This re-interpretation of the long-standing application of the statute will result in a tremendous drain on liquidity that will make trading significantly more expensive for customers hedging their financial or commercial risks, and will adversely affect the ability of many FCMs to operate effectively. It should be noted, that the Commodity Exchange Act has not changed in this regard since 1936 and is silent on the timing of such calculations.

This re-interpretation would require FCMs to assume that ALL margin calls from each customer are simultaneously not able to be collected, resulting in customers being asked to pre-fund their margin or pay to use the capital of the FCM as an injection into the customer account. The costs to the industry as a whole would be significant: Assume a grain elevator places a short corn hedge at the open on Monday morning. During Monday's trading, adverse news drives the price of corn limit up ($0.40). Under the new interpretation, the FCM will need to require the elevator to have sufficient money in the account before placing the trade on Monday to cover initial margin as well as a daily limit move. This "prefunding" is a problem for the elevator because it forces the elevator to keep excess funds at the FCM at all times. It is also a problem for the elevator's bank, because banks will generally not lend for margin until the position has been established and the FCM provides a confirmation of the position to the bank.

The current interpretation was essential to the performance of the futures industry during the 2008 crisis and its application is not related to the shortcomings identified after the recent failures. When the proposal was released the Commission acknowledged that it did not have adequate information to determine the costs of the modified residual interest requirement[3]. Consequently, FIA engaged a consultant to sample FCMs on the potential costs of the residual interest proposal; the results show that this change could require an additional $100 billion obligation to the customer funds accounts, beyond the sum required to meet initial margin requirements. Many of the very customers this proposal is designed to benefit have expressed concerns, both to the CFTC and to this Committee, as they rightfully realize that the proposal will significantly increase the costs of hedging and likely have the largest impact on small to mid-sized FCMs which could potentially lead to consolidation and fewer choices for them as customers. As previously mentioned, the FIA supports many of the customer protection measures that the Commission has proposed we simply believe this one in particular has not been justified and is not warranted.

The FIA is very engaged in the development of industry and Commission-initiated efforts to proactively address many of the issues presented by these recent failures. While the derivatives industry is strong, and clearing continues to be the gold standard in protecting market participants from the unexpected failure of counterparty, we recognize that the collateral necessary for a robust clearing system, and the customers who post such margin, are better protected through enhanced disclosures, reporting, and internal controls. Our members commit a substantial amount of their own capital to guarantee customer transactions. We have every incentive to ensure that the integrity of the derivatives clearing system is well-regarded as safe and reliable.

Clearing Under the Dodd-Frank Act

While the last regular review of the statute occurred five years ago under the routine CFTC reauthorization process, the Commodity Exchange Act has undergone significant changes as

[3] See 77 FR 67916

recently as three years ago, when under the Dodd-Frank Act, Congress determined to extend clearing beyond futures to swaps. As such, the role of the FCMs has also expanded. Because FCMs play a critical role in achieving the newly-established clearing regime for swaps, we are happy to offer our thoughts on the implementation of these requirements.

To date, much of the debate surrounding the implementation of the swaps clearing requirements under the Dodd-Frank Act has been focused on who, what, when and where, rather than how. Often, public attention to Title VII implementation has been devoted to what products will be subject to the clearing mandate; who will be expected to comply with the mandate; when they will be expected to comply; and where, within the global markets, the products and participants will be regulated – all very important questions, but far less discussion has been devoted to how the mechanics of clearing are being impacted. It must not be overlooked that both derivatives clearing organizations and FCMs face tremendous structural changes under some of the new rules, despite the fact that neither of these regulated entities were a contributing factor in the financial crisis. Quite the opposite—the regulated and cleared futures markets worked extraordinarily well during this financial stress, which is the principal reason that the futures markets are serving as the model for this new swaps marketplace. Certainly, the regulatory policies and benefits that have historically existed for clearing futures can largely be applied to swaps – I believe that is what Congress envisioned when passing the Dodd-Frank Act. There will obviously be the occasional exception necessitated by the fact that swaps and futures have evolved in different environments. However, there is no need to re-invent the already proven system that is familiar and tested for futures, especially at this critical juncture, when the newly required clearing mandate for swaps is beginning to take effect. Further, it is important as we implement these important changes in the market structure for swaps that we don't irreparably damage the futures markets that have served our industry well over the last decades. FIA members want a safe and transparent system and want to be constructive in helping to build it. FCMs stand ready and willing to facilitate the clearing of swaps, just as they have for futures. It is for this reason that FIA

discourages policies that complicate the process, especially given the existence of familiar rules that have long governed the clearing of futures.

Conclusion

In general, markets function more effectively and with less disruption when the rules of engagement are clear, simple and transparent and when there is enough time for businesses to adjust their activities to achieve compliance.

I am fortunate to represent a wide array of stakeholders in the listed, cleared and regulated derivatives industry – all of whom want to see this industry continue to support the risk management needs of its customers in a productive way. This is a goal I know the members of this Committee share and I look forward to working with you as you consider the CFTC's role in achieving this mutual objective.