OVERSIGHT OF THE SWAPS AND FUTURES MARKETS: RECENT EVENTS AND IMPENDING REGULATORY REFORMS

HEARING

BEFORE THE

COMMITTEE ON AGRICULTURE
HOUSE OF REPRESENTATIVES

ONE HUNDRED TWELFTH CONGRESS

SECOND SESSION

JULY 25, 2012

Serial No. 112–34

Printed for the use of the Committee on Agriculture
agriculture.house.gov

U.S. GOVERNMENT PRINTING OFFICE

75–437 PDF WASHINGTON : 2013

For sale by the Superintendent of Documents, U.S. Government Printing Office
Internet: bookstore.gpo.gov Phone: toll free (866) 512–1800; DC area (202) 512–1800
Fax: (202) 512–2104 Mail: Stop IDCC, Washington, DC 20402–0001

CONTENTS

WITNESSES

OVERSIGHT OF THE SWAPS AND FUTURES MARKETS: RECENT EVENTS AND IMPENDING REGULATORY REFORMS

WEDNESDAY, JULY 25, 2012

HOUSE OF REPRESENTATIVES,
COMMITTEE ON AGRICULTURE,
Washington, D.C.

The Committee met, pursuant to call, at 10:05 a.m., in Room 1300 of the Longworth House Office Building, Hon. Frank D. Lucas [Chairman of the Committee] presiding.

Members present: Representatives Lucas, Goodlatte, King, Neugebauer, Conaway, Schmidt, Thompson, Stutzman, Tipton, Southerland, Crawford, Huelskamp, Gibson, Hultgren, Hartzler, Schilling, Noem, Peterson, Holden, Boswell, Baca, David Scott of Georgia, Cuellar, Costa, Schrader, Kissell, Owens, Pingree, Courtney, Welch, Fudge, and McGovern.

Staff present: Jason Goggins, Tamara Hinton, Kevin Kramp, Josh Mathis, Matt Perin, John Porter, Nicole Scott, Pete Thomson, Suzanne Watson, Liz Friedlander, C. Clark Ogilvie, John Konya, Margaret Wetherald, Jamie Mitchell, and Caleb Crosswhite.

OPENING STATEMENT OF HON. FRANK D. LUCAS, A REPRESENTATIVE IN CONGRESS FROM OKLAHOMA

The CHAIRMAN. This hearing of the Committee on Agriculture entitled, *Oversight of the Swaps and Futures Markets: Recent Events and Pending Regulatory Reforms,* will come to order. I now recognize myself for an opening statement.

Good morning, and thank you for joining us for this important hearing. I would like to first thank the Ranking Member and his staff for their efforts today, and I would also like to thank our witnesses for their time.

It is beyond unfortunate that for a second time in less than a year, this Committee is examining the circumstances of a futures commission merchant bankruptcy where customer funds were not properly segregated. Once again the very cornerstone of the futures markets, customer funds' segregation, has been severely and suddenly called into question.

For decades, futures markets have been a trusted tool for farmers, ranchers, and businesses seeking to manage risk. The bedrock of their trust in these markets is based on the fundamental protections provided by mandatory segregation of customer funds. Additionally, confidence in the futures and swaps markets stems from customers knowing that regulators are doing their job.

As we all know, on July 10, the National Futures Association halted the operations of PFGBest and the CFTC filed a Federal suit against the firm and its founder alleging that the company had committed fraud, violated customer segregation laws, and falsified financial statements filed with the CFTC. Later that day, the company filed for bankruptcy. Press reports indicated that roughly $220 million in segregated client money is missing.

The clients of firms like PFGBest and MF Global are our constituents. They are farmers and ranchers who until recently have never had cause for concern in using the futures markets. They have never had to worry that the tool for managing risk would one day turn risky and cast doubt on the integrity of the futures markets.

In light of the bankruptcy, CFTC has adopted new rules to strengthen their controls over the treatment and monitoring of customer funds, and the self-regulating organizations have proposed several new initiatives that the Committee will examine today that would ensure another fraud in the futures markets cannot be carried out for years simply by opening a P.O. box.

But the question remains: who is minding the store? There are some in this town who argue that we need more regulations. But the fact remains that new regulations mean nothing when regulators are not enforcing the existing rules on the books. What we need is regulators doing their job.

And it is worth noting that CFTC gave itself high marks for direct examinations of futures brokers in a 2011 performance analysis. Yet billions of dollars in customer funds are missing today as the result of CFTC's failure to perform with MF Global and now PFGBest.

Today we hope to gain a comprehensive understanding of the facts surrounding PFGBest's bankruptcy and the failure to miss such an outright fraud, in addition to an update on MF Global and recent Dodd-Frank rules that have been finalized by the CFTC.

I thank everyone in attendance today. I look forward to hearing from our witnesses.

[The prepared statement of Mr. Lucas follows:]

PREPARED STATEMENT OF HON. FRANK D. LUCAS, A REPRESENTATIVE IN CONGRESS FROM OKLAHOMA

Good morning.

Thank you for joining us for this important hearing. I'd first like to thank the Ranking Member and his staff for their efforts today. I'd also like to thank our witnesses for their time.

It is beyond unfortunate that for a second time in less than a year, this Committee is examining the circumstances of a futures commission merchant bankruptcy where customer funds were not properly segregated.

Once again the very cornerstone of the futures markets, customer funds segregation, has been severely and suddenly called into question.

For decades, futures markets have been a trusted tool for farmers, ranchers, and businesses seeking to manage risk. The bedrock of their trust in these markets is based on the fundamental protections provided by mandatory segregation of customer funds.

Additionally, confidence in the futures and swaps markets stems from customers knowing that regulators are doing their job.

As we all know, on July 10, the National Futures Association halted the operations of PFGBest and the CFTC filed a Federal suit against the firm and its founder, Mr. Russell Wasendorf, Sr., alleging that the company had committed fraud, violated customer segregation laws, and falsified financial statements filed with the

CFTC. Later that day, the company filed for bankruptcy. Press reports indicate that roughly $220 million in segregated client money is missing.

The clients of firms like PFGBest and MF Global are our constituents. They are farmers and ranchers who until recently have never had cause for concern in using the futures markets. They've never had to worry that the tool for managing risk would one day turn risky and cast doubt on the integrity of the futures markets.

In light of the bankruptcy, CFTC has adopted new rules to strengthen their controls over the treatment and monitoring of customer funds. And, the self regulatory organizations have proposed several new initiatives that the Committee will examine today that would ensure another fraud in the futures markets cannot be carried out for years simply by opening a P.O. box.

But the question remains: who is minding the store? There are some in this town who argue that we need more regulations. But the fact remains that new regulations mean nothing when regulators are not enforcing the existing rules on the books. What we need is regulators doing their job.

It is worth noting that CFTC gave itself high marks for direct examinations of futures brokers in a 2011 performance analysis. Yet, billions of dollars in customer funds are missing today as the result of CFTC's failure to perform with MF Global and now PFGBest.

Today, we hope to gain a comprehensive understanding of the facts surrounding PFGBest's bankruptcy and the failure to miss such an outright fraud, in addition to an update on MF Global and recent Dodd-Frank rules that have been finalized by the CFTC.

Thank you. I look forward to hearing from our witnesses today.

The CHAIRMAN. I now recognize the Ranking Member for his opening statement.

OPENING STATEMENT OF HON. COLLIN C. PETERSON, A REPRESENTATIVE IN CONGRESS FROM MINNESOTA

Mr. PETERSON. Thank you, Mr. Chairman, and thank you for this hearing.

You know, I had an opportunity yesterday to visit with NFA trying to get an understanding. I am a CPA, as Mr. Conaway is, but I am not much of an auditor—I was more of a tax guy—the auditing I did do, you always sent the confirmation directly to the bank and the bank sent it directly back to you. I couldn't understand how you could have a situation where he could intercept that and forge that. Somehow or another he gave them a Post Office box that they thought was the bank. I don't know how that happened or what you can do about it. Now, they are moving toward e-audit, and that is what smoked this guy out and apparently precipitated his suicide attempt. They are going to now implement that and that sounds like that will fix this problem or largely fix it.

But we are continuing to chase these problems all the time, and I am not sure that these regulators can ever get ahead of this. As with farmers, we can pass a farm bill but those guys are so far ahead of us that they sit on the tractor and they figure this stuff out before we ever decide how to work things. I think we have something going on like that in these markets.

You know, these FCMs, as I understand it, no longer make their money by charging commissions for what they do. The way they have been making their money is by investing customer money and using the money they earn on the customer money to fund their business. Now, this is crazy, and especially in an interest-rate climate where we have zero percent interest and the government is going in and continuing zero percent interest. To some extent we are causing this problem because we are putting pressure on these guys to make enough money to stay in business, and then this is what happens.

We have a self-regulatory situation: the CFTC doesn't have enough people to go out and audit all these folks. We are trying to cut their budget, not raise it. I think these hearings are good to look at these things, but we may need to step back and take a look at how we got into this situation. I would like to see us go back and look at the CFMA in 2000, and we never have really examined what we did with that bill when we deregulated these markets. That is one thing, but the second thing we did is give legal certainty to these swaps and created this huge—at the time, I think there was $80 billion in these derivative markets. It went to $600 trillion in 8 years because we gave them legal certainty. Well, this is the government, actually it is a regulation, us interfering in the marketplace to say that these things are not gambling. If we say it is not gambling when it actually is gambling, and if we would have left that alone, I don't think we would be dealing with some of these things that we are dealing with now.

So, we should go back and look at what we did and get some people to give us some kind of a sense of what our culpability in this whole situation is. When we did Dodd-Frank, we would not bite the bullet and we have these regulators forced to harmonize regulations when they have completely different cultures. There are three different regulators involved in the same situation, and then you wonder why it doesn't work. So I don't know.

The regulators are doing as best as they can given the tools that they have. But, these folks that are in these markets have not learned a damn thing from anything that has happened so far and there are apparently a bunch of dishonest people in here and you are not going to catch them all, all the time. I would like to see us spend some time taking a look at what we have done as we are looking at all these government regulations. Let us look, did we—by getting involved in this—cause problems on the other side of things.

I read the other day where now these securitization people that were making all this money by securitizing these mortgages, and that business dropped up because it all blew up. Now they can't even decide who should run these foreclosed houses and they are blaming different people and saying well, we are not in charge and they are in charge. Nobody is in charge and they are deteriorating, which is the fundamental problem with that whole deal. But now these guys are going out and buying these foreclosed properties. They are taking the rental income from the foreclosed properties and they are securitizing it so they can raise money to go buy more foreclosed property. This is another thing that is going to blow up if this gets to be a big deal. So we need to look at the bigger picture sometimes and not be chasing these problems all the time, for whatever it is worth.

I yield back.

[The prepared statement of Mr. Peterson follows:]

PREPARED STATEMENT OF HON. COLLIN C. PETERSON, A REPRESENTATIVE IN CONGRESS FROM MINNESOTA

Good morning. Thank you, Chairman Lucas, for yielding.

I appreciate that we're meeting today to review some important issues. But frankly I'd rather be on the House floor debating the farm bill and think a majority of us on the Committee would agree. We still have a few days before the August recess; I hope everyone keeps the pressure on Leadership so we can wrap this up before leaving town. There's really no good excuse not to get this done.

I know some in Leadership question whether there are enough votes to pass the farm bill. Now, if they want to pass a partisan, Republican-only bill, which seems to be the case around here, I wish them luck because they're going to need it. However, if they are willing to consider a bipartisan farm bill and work in the same bipartisan fashion as the Agriculture Committee, I stand ready to round up Democratic votes. When I was Chairman, I got 19 Republicans to join me when we first passed the farm bill in 2007. I know I can bring more Democrats than that onboard for the bipartisan bill passed by this Committee. Right now, I'm just waiting for Leadership to call.

Until then, there is other work to do which is why we're here today.

CFTC oversight has long been a priority for this Committee. Recent events including the fraud at Peregrine Financial Group and the LIBOR manipulation—both of which were occurring during the reign of previous CFTC Chairmen—on top of the MF Global bankruptcy, have again raised concerns regarding financial oversight. I hope that both Chairman Gensler and the witnesses on the second panel will be able to shed some light on who knew what when, and what steps are being taken to ensure we don't find ourselves discussing yet another financial scandal in the coming months.

Of course, the CFTC is still in the process of finalizing many of the rules that will create a more open and transparent derivatives market. I've said repeatedly that we need to give them the time to get the rules right and, by and large, they are getting them right. We also need to give them the necessary resources to do their work.

So, I look forward to hearing from our witnesses and thank the chair for holding today' s hearing.

The CHAIRMAN. The Ranking Member yields back.

The chair would request that other Members submit their opening statements for the record so the witnesses may begin their testimony, and to ensure that there is ample time for questions.

[The prepared statement of Mr. Conaway follows:]

PREPARED STATEMENT OF HON. K. MICHAEL CONAWAY, A REPRESENTATIVE IN CONGRESS FROM TEXAS

Mr. Chairman, I want to thank you for convening this hearing today. Over the past several months, the financial services industry has continued to garner headlines; unfortunately not often for flattering reasons. We have seen a large trade go public awry; another Futures Commission Merchant has failed and lost significant amounts of customer funds; the first of many banks has faced an enforcement order for fixing international benchmark financial rates; and a large international bank has admitted to allowing drug cartels and international terrorists launder money.

At the same time, the CFTC has continued to work through the remaining Dodd-Frank rulemakings. Earlier this month, the final product definition rules were issued, starting a 60 day clock running for swap dealers to register. Confounding this process, however, is that the guidance intended to clarify the extraterritorial application of the CFTC's new regulatory powers has only further confused market participants and raised the ire of international regulators.

All in all, Mr. Chairman, today is a good day for a hearing to begin the process of sorting through some of these knotty issues. Today's hearing is not about assigning blame or finding fault for any particular event, it is about how to make the system work better for market participants and most importantly, the end-users who rely on the financial system to work correctly every single day.

The recent failures and other shortcomings of the industry show that there is much work to be done. Each crisis we see erodes the publics' trust in the institutions—both private firms and the regulators alike—that are essential to our economic growth.

Less visible to the public, but certainly no less important, are the barrage of rulemakings that the CFTC has been finalizing over the past year. These rules will be the new regulatory foundation that Americans believe will prevent another financial meltdown. The size, scope, and frequency of the failures that will inevitably occur under this new regime will determine the trust that Americans continue to place in regulators of high finance.

I continue to worry about the sequencing and timing of the rules, as well as the refusal of the CFTC to conduct quantitative and qualitative cost-benefit analysis. In particular, with the Extraterritoriality guidance that was recently issued. I am troubled that by choosing to issue guidance instead of proposing a rule, the Commission has circumvented the need to perform any analysis of the costs or the benefits of its guidance to market participants or end-users. The guidance may well have consequences that the Chairman's staff did not think of which could be detrimental to the ability for firms to participate in these newly regulated markets.

I would like to close by thanking each of our panel participants for your participation today and your unfailing willingness to work with our Committee to improve the regulation and oversight of the futures and derivatives markets. While we may not always see eye to eye on every issue, I appreciate the honest and direct discussions that I have had with many of you about how to improve the financial systems we all care so deeply about.

The CHAIRMAN. I would like to welcome first panel witness to the table, the Hon. Gary Gensler, Chairman of the U.S. Commodity Futures Trading Commission, Washington, D.C.

Mr. Chairman, please begin when you are ready.

STATEMENT OF HON. GARY GENSLER, CHAIRMAN, COMMODITY FUTURES TRADING COMMISSION, WASHINGTON, D.C.

Mr. GENSLER. Good morning, Chairman Lucas, Ranking Member Peterson, and Members of the Committee.

When we were all kids growing up, we learned in courses like history, science, and math that we have to rely on hard facts, figures and research, and the markets rely on hard facts, figures and research too. So when President Roosevelt and Congress came together in the 1930s with the great reforms in that era, I think they really said let us give the public the hard facts, figures and research on the securities and futures market. They knew that markets work best when the broad public has access to the same facts and figures as sophisticated insiders have. I believe these critical reforms of the 1930s are at the foundation of our strong capital markets and many decades of economic growth thereafter.

Swaps subsequently emerged in the 1980s, as we know, to help companies manage their risk. The financial crisis in 2008—revealed in part to be because the swaps market had not been regulated led to eight million Americans losing their jobs. Congress came together in response, similar to in the 1930s, and said the public should have the facts, figures and research on the swaps marketplace so they can have confidence in this marketplace as they did in the 1930s reform that preceded it.

The Commission has made significant progress in these commonsense reforms with 36 rules completed. We are increasingly moving from rule writing to implementation of reform. Light will begin to shine on the swaps market this fall when swaps price and volume information will be publicly reported in real time. Regulators will get a fuller picture by seeing information in data repositories and the dealers in the marketplace will begin to come under comprehensive regulation with phasing of those requirements following afterwards. We have just under 20 further rules to complete, and reform will also mean once complete that buyers and sellers will meet in a transparent market and compete with each other, and help end-users get better prices.

Standardized swaps will be centrally cleared, which will help lower risk in the marketplace and reform will include cross-border transactions that affect the U.S. economy. Time and again we find that crises come back to our shores from the Cayman Islands or London if it is an affiliate or branch of a U.S. entity.

Let me now just turn to two recent enforcement matters, Barclays and Peregrine. Each of these matters reminds me of a saying that my grandfather, who had immigrated from Russia, used to say. Simply put, he said "Figures don't lie but liars sure can figure." I heard this so many times from my mom growing up. LIBOR and Euribor, which Barclays attempted to manipulate and falsely reported, are at the center of the capital markets for both borrowing and derivatives contracts. One could say it is the mother of all benchmarks. Hundreds of trillions of dollars of transactions here and abroad are based on LIBOR. For instance, at the Chicago Mercantile Exchange, nearly 70 percent of the notional value of their futures markets—we are not even talking about swaps yet—nearly 70 percent of the notional value of their futures contracts somehow settled to or priced off of these benchmark rates. If my grandfather were alive today, he would be shaking his head but he wouldn't be so surprised. LIBOR has a structural problem. It is supposedly based on what banks perceive to be their borrowing rates in the unsecured interbank market but what if facts, figures and research are limited? What if there is not such borrowings that exist? They have to put in their best estimates, I guess, but I believe it is critical for markets to have an honest transaction-based benchmark, whether that means changing LIBOR or moving to another rate for the markets to work off of. I am pretty sure my grandfather would agree with that.

The recent events at Peregrine would have caught my grandfather's attention even more so. Simply put, the evidence points at the owner, Russ Wasendorf, taking customers' funds right out of the bank and lying about it for years. The National Futures Association, the self-regulatory organization responsible for frontline oversight of Peregrine, is required to conduct periodic audits of Peregrine's customer funds. In addition, independent certified public accountants audited Peregrine's annual financial statements. But just like the local police cannot prevent all bank robberies, market regulators cannot prevent all financial fraud. Having said that, the system clearly failed to protect Peregrine's customers and I believe we all must do better.

The Commission has been actively working to improve protections of customer funds and we finalized four separate rules including rules related to investing of customer funds, which you may have heard was rule 1.25, gross margining that will go into effect later this year, segregation for swaps and rules working closely with the CME, FIA, and NFA that the SROs have various new requirements concerning customer segregated accounts.

The CFTC is also implementing a significant restructuring of how we oversee the SROs and intermediaries. We hired new leadership about 9 months ago but there is much more to do. Looking forward, I believe it is critical that we further update our rules giving regulators direct electronic access to all bank and custodial accounts holding customer funds.

We will conduct a full review of the CFTC's and SRO examination and audit oversight of futures commission merchants looking only for improvements including getting advice from the Public Company Accounting Oversight Board, who has graciously said that they will give us advice on how they look at the auditing profession and see how we can learn from the PCAOB and what they do.

We must do everything within our authorities and resources to strengthen our oversight programs and protection of customer funds. We must do it for the public. I also think I want to keep my grandfather's values and wise admonition in mind about figures and liars. Thank you.

[The prepared statement of Mr. Gensler follows:]

PREPARED STATEMENT OF HON. GARY GENSLER, CHAIRMAN, COMMODITY FUTURES TRADING COMMISSION, WASHINGTON, D.C.

Good morning, Chairman Lucas, Ranking Member Peterson, and Members of the Committee. I thank you for inviting me to today's hearing on oversight of the swaps and futures markets. I will review the Commodity Futures Trading Commission's (CFTC) implementation of the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act), as well as the recent events related to the London Interbank Offered Rate (LIBOR) and Peregrine Financial Group.

I also thank my fellow Commissioners and CFTC staff for their hard work and commitment.

The 2008 crisis—caused in part by swaps—was the worst economic crisis Americans have experienced since the Great Depression. Eight million Americans lost their jobs, millions of families lost their homes and thousands of businesses shuttered.

Following the crisis, the President and the G20 leaders convened in Pittsburgh in September 2009 and agreed that swaps, which were basically not regulated in the United States, Asia or Europe, should now be brought into the light of regulation.

In 2010, Congress and the President came together and passed the historic Dodd-Frank Act.

The goal of the law's swaps market reforms is to:

- Bring public market transparency and the benefits of competition to the swaps marketplace;
- Lower the risk of the interconnected financial system by bringing standardized swaps into centralized clearing; and
- Ensure that swap dealers and major swap participants are specifically regulated for their swaps activity.

The Commission has made significant progress in implementing Congress' direction to ensure that common-sense standards are established for the swaps market.

Turning Point: Implementation of Swaps Market Reforms

Throughout the rule-writing process, we have benefitted from significant public input. CFTC Commissioners and staff have met nearly 1,800 times with the public, and we have held 18 public roundtables on important issues related to Dodd-Frank reform. The agency has received more than 35,000 comment letters related to Dodd-Frank rules.

Last summer, we turned the corner and started finalizing rules. To date, we've completed 36 rules and now have fewer than 20 to go (see attachment).

This month, we reached another major turning point in the swaps market reform process. The CFTC and the Securities and Exchange Commission (SEC) completed the rule to further define the terms "swap" and "security-based swap." These further product definitions mean many other critical swaps market reforms already completed by the Commission will come to life. We also finalized this month the rule on the end-user exception to clearing. With the completion of these foundational rules, we are increasingly moving from the rule-writing process to the implementation of reforms that bring transparency to the swaps marketplace and lower its risks to the public.

Swap dealers, for the first time, will register and begin to come under comprehensive regulation. This includes implementing already completed external and internal business conduct standards that will lower swap dealers' risk to the economy and promote confidence in their integrity.

Two months after the rule further defining the term "swap" is published in the *Federal Register,* light will begin to shine on the swaps market. Initially, likely by October, swaps price and volume information will be reported in real time to the public for interest rate and credit default swap (CDS) indices. Three months later, such real-time reporting will begin for energy and other physical commodity swaps.

Swap data repositories (SDRs) will receive data on all swaps transactions, giving regulators their first full window into these markets. One SDR has already successfully registered with the Commission, and we have at least four other parties working on their applications.

The rule further defining "swap" is especially meaningful for the implementation of position limits. For the first time, limits will apply to the aggregate spot-month positions, including both futures and swaps. Spot-month limits protect the markets against corners, squeezes and the burdens that may come from excessive speculation.

I will now go into further detail on the Commission's swaps market reform efforts.

Transparency

Transparency is critical to both lowering the risk of the financial system, as well as to reducing costs to end-users. The more transparent a marketplace is to the public, the more efficient it is, the more liquid it is, and the more competitive it is.

We have completed the bulk of the Congressionally mandated transparency reforms for the swaps market. This fall real-time reporting to the public and to regulators will begin for swaps market transactions.

Second, detailed and up-to-date reporting by large traders in the physical commodity swaps markets began last fall. This reporting allows regulators to better police for fraud, manipulation and other abuses.

Third, the CFTC also plans to begin publishing aggregated swaps market data. The public has benefited for years from the Commitment of Traders futures data we publish. Our goal is to provide similar public transparency for the swaps market.

Fourth, in May we completed rules, guidance and acceptable practices for designated contract markets (DCMs). DCMs will be able to list and trade swaps, helping to bring the benefit of pre-trade transparency to the swaps marketplace.

Looking forward, we have two important transparency rules to complete related to block sizes and swap execution facilities (SEFs). These critical Dodd-Frank reforms will bring pre-trade transparency to the swaps market for the benefit of all the end-users that use swaps.

Central Clearing

For over a century, through good times and bad, central clearing in the futures market has lowered risk to the broader public. Dodd-Frank financial reform brings this effective model to the swaps market. Standard swaps between financial firms will move into central clearing, which will significantly lower the risks of the highly interconnected financial system.

The CFTC has made significant progress on central clearing for the swaps market. We have completed rules establishing new derivatives clearing organization risk management requirements.

Second, to further facilitate broad market access, we completed rules on client clearing documentation, risk management, and so-called "straight-through processing," or sending transactions immediately to the clearinghouse upon execution.

Third, we completed the rule on the end-user exception to clearing. Consistent with Congressional intent, this rule ensures that end-users using swaps to hedge or mitigate commercial risk will not be required to bring swaps into central clearing.

Fourth, the CFTC this month also proposed a rule that would permit certain cooperatives to choose not to clear member-related swaps. Cooperatives act on behalf of and are an extension of their members. Thus, I believe it is appropriate that in certain circumstances, those cooperatives made up entirely of members that could individually qualify for the end-user exception should qualify as end-users.

Fifth, yesterday the Commission adopted the final rule for phased implementation of compliance with the clearing requirement for various groups of financial entities.

Sixth, the Commission also yesterday approved proposed clearing requirement determinations based upon clearinghouse submissions on swaps they already clear. The clearing determinations begin with standard interest rate swaps in U.S. dollars, Euros, British pounds and Japanese yen, as well as a number of CDS indices, including North American and European corporate names.

In addition, the Commission has adopted four important customer protection enhancements: the amendments to rule 1.25, the gross margin rule, the LSOC rule for swaps and rules on the minimum requirements for SROs regarding their financial surveillance of FCMs.

Based upon the Dodd-Frank 90 day clock for making clearing determinations, the first clearing determinations may be finalized in October just before the gross margin and LSOC rules go into effect November 8.

The CFTC also has received substantial public input on the clearing of swaps among affiliates of the same financial entity. The staff recommendation, which would exempt certain affiliate swaps from the clearing requirement, is under review by Commissioners.

Swap Dealers

Regulating banks and other firms that deal in swaps is central to financial reform. Prior to 2008, it was claimed that swap dealers did not need to be specifically regulated for their swaps activity, as they or their affiliates already were generally regulated as banks, investment banks, or insurance companies. The crisis revealed the inadequacy of relying on this claim. While banks were regulated for safety and soundness, including their lending activities, there was no comprehensive regulation of their swap dealing activity. Similarly, bank affiliates dealing in swaps, and subsidiaries of insurance and investment bank holding companies dealing in swaps, were not subject to specific regulation of their swap dealing activities. AIG, Lehman Brothers and other failures of 2008 demonstrate what happens with such limited oversight.

The CFTC is well on the way to implementing reforms Congress mandated in Dodd-Frank to regulate dealers and help prevent another AIG. The Commission has finished sales practice rules requiring swap dealers to interact fairly with customers, provide balanced communications and disclose conflicts of interest before entering into a swap. In addition, the Commission has finalized internal business conduct rules to require swap dealers to establish policies to manage risk, as well as put in place firewalls between a dealer's trading, and clearing and research operations. Staff recently provided to Commissioners recommendations on a final rule on swap relationship documentation, confirmations and portfolio compression.

We completed in April a joint rule with the SEC further defining the terms "swap dealer" and "security-based swap dealer."

Based upon completed registration rules and the recently completed joint rule further defining the term "swap," we anticipate dealers will begin registering with the National Futures Association (NFA) in the early fall.

The CFTC has been working with the Federal Reserve, the other U.S. banking regulators, the SEC, and international regulators and policymakers to align margin requirements for uncleared swaps. It is essential that we align these requirements globally, particularly between the major market jurisdictions. The international approach to margin requirements in the consultative paper (sponsored by the Basel Committee on Banking Supervision and the International Organization of Securities Commissions) released this month is consistent with the approach the CFTC laid out in its margin proposal last year. It would lower the risk of financial entities, promote clearing and help avoid regulatory arbitrage. Consistent with the CFTC's proposal, it also excludes non-financial end-users from margin requirements for uncleared swaps.

The CFTC reopened the comment period on our margin proposal so that we can hear further from market participants and the public in light of the work being done to internationally harmonize margin rules. As we work with international regulators on this coordinated approach, I would anticipate that the Commission would only take up the final margin rules toward the end of this year.

Following Congress' mandate, the CFTC also is working with our fellow financial regulators to finalize the rulemaking to implement the Volcker Rule. In adopting the Volcker Rule, Congress prohibited banking entities from engaging in proprietary trading, an activity that may put taxpayers at risk. At the same time, Congress permitted banking entities to engage in certain activities, such as market making and risk mitigating hedging. One of the challenges in finalizing a rule is achieving these multiple objectives.

Staff also has provided to Commissioners recommendations in two other areas. The first relates to proposed exemptions for certain transactions in the electricity markets. In particular, this includes possible exemptive orders for certain transactions executed on regional transmission organizations, as well as between and among rural electric cooperatives and municipal public power providers. Second, now that the Commission made significant progress on swaps market reforms, we will consider completing a number of conforming rules.

Market Integrity/Position Limits

Financial reform also means investors, consumers, retirees and businesses in America will benefit from enhanced market integrity. Congress provided the Commission with new tools in Dodd-Frank to ensure the public has confidence in U.S. swaps markets.

Rules the CFTC completed last summer close a significant gap in the agency's enforcement authorities. The rules implement important Dodd-Frank provisions extending our enforcement authority to swaps and prohibiting the reckless use of manipulative or deceptive schemes. Thus, for example, the CFTC has clear anti-fraud and anti-manipulation authority regarding the trading of credit default swaps indices.

Also, the CFTC now can reward whistleblowers for their help in catching market misconduct.

Congress also directed the CFTC to establish aggregate position limits for both futures and swaps in energy, agricultural and other physical commodities. In October 2011, the Commission completed final rules to ensure no single speculator is able to obtain an overly concentrated aggregate position in the futures and swaps markets. With the recently completed joint rule further defining "swap," compliance for all spot-month limits will go into effect in approximately 2 months.

The Commission approved a proposed rule in May that would modify the CFTC's aggregation provisions for limits on speculative positions. The proposal would permit any person with a 10 to 50 percent ownership or equity interest in an entity to disaggregate the owned entity's positions, provided there are protections and firewalls in place to ensure trading decisions are made independently of one another.

Two associations representing the financial industry are challenging the agency's final rule establishing position limits in court. The Commission is vigorously defending the Congressional mandate to implement position limits in court.

Cross-Border Application of Dodd-Frank's Swaps Market Reforms

The nature of modern finance is that large financial institutions set up hundreds, if not thousands, of "legal entities" around the globe. Many of these far-flung legal entities, however, are still highly connected back to their U.S. affiliates.

The lessons of the 2008 crisis and earlier have demonstrated that time and again financial transactions executed offshore by U.S. financial institutions can send risk straight back to our shores. It was true with the London and Cayman Islands affiliates of AIG, Lehman Brothers, Citigroup and Bear Stearns. A decade earlier, it was true, as well, with the collapse of the hedge fund Long-Term Capital Management.

During a default or crisis, the risk that builds up offshore inevitably comes crashing back onto U.S. shores. The recent events of JPMorgan Chase, where it executed swaps through its London branch, are a stark reminder of this reality of modern finance.

Section 722(d) of the Dodd-Frank Act states that swaps reforms shall not apply to activities outside the United States unless those activities have "a direct and significant connection with activities in, or effect on, commerce of the United States." Congress included this provision for swaps, but included a different provision with regard to the SEC's oversight of the security-based swaps market.

The Commission, consulting closely with the SEC, the Federal Reserve and the Treasury Department, recently proposed guidance interpreting this section of the law. The Commission also proposed in a separate release phased compliance for foreign swap dealers (including overseas affiliates of U.S. swap dealers) of certain requirements of Dodd-Frank swaps market reform. Such phased compliance would enable market participants to comply with the Dodd-Frank Act in an orderly fashion and allow time for the CFTC to receive public comment on the cross-border interpretive guidance.

The proposed guidance interpreting Section 722(d) includes the following key elements:

First, it provides the guidance that when a foreign entity transacts in more than a *de minimis* level of U.S. facing swap dealing activity, the entity would register under the Dodd-Frank Act swap dealer registration requirements.

Second, it includes a tiered approach for foreign swap dealer requirements. Some requirements would be considered entity-level, such as for capital, chief compliance officer, risk management, swap data record-keeping, reporting to swap data repositories and large trader reporting. Some requirements would be considered transaction-level, such as clearing, margin, real-time public reporting, trade execution, trading documentation and sales practices.

Third, entity-level requirements would apply to all registered swap dealers, but in certain circumstances, foreign swap dealers could meet these requirements by complying with comparable and comprehensive foreign regulatory requirements, or what we call "substituted compliance."

Fourth, transaction-level requirements would apply to all U.S. facing transactions. For these requirements, U.S. facing transactions would include not only transactions with persons or entities operating or incorporated in the United States, but also transactions with their overseas branches. Likewise, this would include transactions with foreign affiliates that are guaranteed by a U.S. entity, as well as the foreign affiliates operating as conduits for a U.S. entity's swap activity. Foreign swap dealers, as well as overseas branches of U.S. swap dealers, in certain circumstances, may rely on substituted compliance when transacting with foreign affiliates guaranteed by or operating as conduits of U.S. entities.

Fifth, for certain transactions between a foreign swap dealer (including an overseas affiliate of a U.S. person) and foreign counterparties not guaranteed by or operating as conduits for U.S. entities, Dodd-Frank transaction-level requirements may not apply. For example, this would be the case for a transaction between a foreign swap dealer and a foreign insurance company not guaranteed by a U.S. person.

LIBOR

I'd like now to review the CFTC's recent order against Barclays concerning the benchmarks LIBOR and Euribor.

People taking out small business loans, credit cards and mortgages, as well as big companies involved in complex transactions, all depend upon the honesty of benchmark rates like LIBOR for the cost of their borrowings. Banks must not attempt to influence LIBOR, Euribor or other indices based upon concerns about their reputation or the profitability of their trading positions.

LIBOR and Euribor are indices at the center of the capital markets for both borrowings and derivatives contracts. LIBOR is the reference index for the largest open interest of contracts in both the U.S. futures markets and swaps markets. As of the end of June, the 3 month Eurodollar futures contracts that settle to U.S. Dollar LIBOR make up about 70 percent of the notional value of all futures contracts traded on the CME Group exchanges. U.S. Dollar LIBOR's traded volume in 2011 on the CME was a notional value exceeding $564 trillion. According to the British Bankers Association, swaps with a total notional value of approximately $350 trillion and loans amounting to $10 trillion are indexed to LIBOR.

The CFTC initiated in April of 2008 a review of LIBOR after media reports raised questions about the integrity of the index. Thereafter, we began coordinating with the United Kingdom's Financial Services Authority (FSA), which helped us facilitate information requests. The FSA and the U.S. Department of Justice subsequently joined the CFTC with regard to the Barclays matter, and it has been a collaborative effort throughout.

To conduct such a complicated case, the CFTC enforcement staff had to sift through a voluminous number of documents and audio recordings that spanned many years.

The CFTC's Order found that Barclays traders and employees responsible for determining the bank's LIBOR and Euribor submissions attempted to manipulate and made false reports concerning both benchmark interest rates to benefit the bank's derivatives trading positions. The conduct occurred regularly and was pervasive. Barclays' traders located at least in New York, London and Tokyo asked Barclays' submitters to submit particular rates to benefit their derivatives trading positions. In addition, certain Barclays Euro swap traders coordinated with and aided and abetted traders at other banks in each other's attempts to manipulate Euribor.

The Order also found that throughout the financial crisis, as a result of instructions from Barclays' senior management, the bank routinely made artificially low LIBOR submissions. Submitters were told not to submit at levels where Barclays was "sticking its head above the parapet." The senior management directive was intended to fend off negative public perception about Barclays' financial condition.

The CFTC's Order required Barclays to pay a $200 million civil monetary penalty for attempted manipulation of and false reporting concerning LIBOR and Euribor. In addition, Barclays is required to implement measures to ensure its future submissions are honest.

Among other things, these requirements included:

- Making submissions based on a transaction-focused methodology;
- Implementing firewalls to prevent improper communications, including between traders and submitters;
- Preparing and retaining documents concerning submissions and certain relevant communications; and

- Implementing auditing, monitoring and training measures concerning submissions and related processes, including making regular reports to the CFTC.

The CFTC has and will continue vigorously to use our enforcement and regulatory authorities to protect the public, promote market integrity, and ensure that these benchmarks and other indices are free of manipulative conduct and false information. The Commodity Exchange Act (CEA) is clear in its prohibitions against attempted and actual manipulation of futures, swaps and commodity prices. Further, the CEA's Section 9(a)(2) prohibits knowingly making false reports of market information that affects or tends to affect the price of a commodity.

The FSA is reviewing the LIBOR benchmark, and will be making suggestions as to how to improve it. Moving forward, the CFTC stands ready to assist the FSA on its review of LIBOR and how to best assure that LIBOR, or any alternative benchmark that might emerge, is not susceptible to attempted manipulation or false reporting. We look forward to working with regulators and market participants here and abroad to ensure that benchmarks for interest rates that touch borrowers and lenders around the globe are reliable and honest.

If these key benchmarks are based on observable transactions, borrowers, lenders and derivatives users around the globe all benefit. If these key benchmarks are not based on observable transactions, I believe their integrity will continue to be subject to question. And if these key benchmarks are not based on honest submissions, we all lose.

Peregrine Financial Group, Inc.

Background

On July 10, the CFTC filed a complaint in Federal court against Peregrine and its sole owner, Russell Wasendorf, Sr., alleging that they misappropriated customer funds from an account held at U.S. Bank.

Criminal authorities arrested Mr. Wasendorf for lying to the CFTC, and they advised the court that they intended to file more criminal charges in the future.

The CFTC's complaint, along with the criminal charges, tells a story of deliberate dishonesty and deception. In a written statement found when he attempted suicide, as quoted in the criminal charges, Mr. Wasendorf said he committed fraud, manufactured phony bank documents, and forged bank signatures. In short, the charges against him are that he took customers' funds right out of the bank, and lied about it for years.

The System of FCM Oversight

Peregrine is a CFTC-registered FCM. The NFA, a futures industry SRO, is responsible for the firm's front-line oversight. The way our oversight system has been set up for decades, SROs are the primary regulators of FCMs, introducing brokers, commodity pool operators, and commodity trading advisors. In 2000, Congress affirmed the Commission's reliance on self-regulatory organizations by amending Section 3 of the CEA to state: "It is the purpose of this Act to serve the public interests . . . through a system of effective self-regulation of trading facilities, clearing systems, market participants and market professionals under the oversight of the Commission." Further, based on this system and the realities of limited CFTC resources, in the wake of Dodd-Frank, the NFA also will take on additional examination and registration duties with regard to swap dealers.

As part of its oversight responsibility, the NFA is required to conduct periodic audits of non-clearing member FCMs' customer funds in segregated and secured accounts. The CFTC oversees the NFA, examining them for the performance of their duties. We review the NFA's work papers only on a limited number of FCMs each year. In addition, the CFTC also does limited-scope reviews of FCMs in a "for cause" situation that are sometimes referred to as "audits," but they are not full-scale audits as accountants commonly use that term.

Under CFTC rules, FCMs must have their annual financial statements audited by an independent CPA using Generally Accepted Auditing Standards. As part of this certified annual report, the independent accountant also must conduct appropriate reviews and tests to identify any material inadequacies in systems and controls that could violate the Commission's segregation or secured amount requirements. Any such inadequacies are also to be reported to the SRO and the Commission.

The Oversight of Peregrine

The NFA last completed an audit of Peregrine in May 2011, and was in the process of conducting another periodic audit over the last several weeks. Peregrine's financials for the year ending December 31, 2011, were reviewed and certified by its independent CPA expressing a clean opinion on both the financial statements and internal controls report.

In 2000, the CFTC brought an enforcement action against Peregrine, finding in an Order that the firm had violated net capital rules. At the time, Peregrine was much smaller than it was in 2012, with roughly $800,000 in net capital requirements and $23 million in customer segregation requirements. The firm was ordered to pay a civil penalty and to take steps to improve its financial controls, including retaining a second independent public accounting firm to perform reviews of certain financial accounts and to report its findings to the CFTC. The firm retained PricewaterhouseCoopers.

The CFTC's Order in 2000, resolving the enforcement investigation, was the culmination of a process that began with limited-scope reviews conducted by the CFTC examinations staff in the 1990s. During these reviews, the staff noted a number of problems at Peregrine regarding, among other things, net capital, infusions of capital to avoid net capital violations, internal financial controls, and records of segregated and secured customer assets and liabilities. Other issues related to accounting for receivables and payables; transactions and agreements with affiliates; differences between journal entries on the company's books and the statements of one of its banks, Harris Bank; accuracy of books and records; the abilities of the firm's auditor; and providing customers with timely trade confirmations and monthly statements. In addition, CFTC staff questioned whether Peregrine had tried to mislead them concerning some of these accounting issues. The staff also noted issues regarding the sufficiency of NFA audits.

Subsequently, in 2007 and 2008, the CFTC examinations staff reviewed Peregrine's classification and reporting of customer-owned securities and the investment of customer funds for compliance with CFTC Regulations. The limited reviews identified improperly titled segregation bank accounts, which were corrected during the examination. In addition, the staff in 2010 performed a limited, 2 day review of Peregrine's anti-money laundering compliance.

Although we do not yet know the full facts of what happened in this matter, it is clear that the system failed to protect the customers of Peregrine. The NFA and CFTC staff over the years did not detect Mr. Wasendorf's alleged stealing of customer funds, which came to light only a few weeks ago. Though the local police cannot prevent every bank robbery and market regulators cannot prevent every financial fraud, we all must do better. We must do everything within our authorities and resources to strengthen oversight programs and the protection of customer funds.

Customer Protection

CFTC Customer Protection Reforms To Date

The Commission has been actively working to improve protections for customer funds. This includes:

- The completed amendments to rule 1.25 regarding the investment of funds bring customers back to protections they had prior to exemptions the Commission granted between 2000 and 2005. Importantly, this prevents use of customer funds for in-house lending through repurchase agreements;
- Clearinghouses will have to collect margin on a gross basis and futures commission merchants (FCMs) will no longer be able to offset one customer's collateral against another and then send only the net to the clearinghouse;
- The so-called "LSOC rule" (legal segregation with operational commingling) for swaps ensures customer money is protected individually all the way to the clearinghouse; and
- The Commission included customer protection enhancements in the final rule for DCMs. These provisions codify into rules staff guidance on minimum requirements for self-regulatory organization (SROs) regarding their financial surveillance of FCMs.

In addition, this month, we approved an NFA proposal that stemmed from a coordinated effort by the CFTC, the SROs, and market participants, including from the CFTC's 2 day roundtable earlier this year on customer protection.

The three key areas of reform included in the NFA rules are:

- First, FCMs must hold sufficient funds in Part 30 secured accounts (funds held for U.S. foreign futures and options customers trading on foreign contract markets) to meet their total obligations to customers trading on foreign markets computed under the net liquidating equity method. FCMs will no longer be allowed to use the alternative method, which had allowed them to hold a lower amount of funds representing the margin on their foreign futures;

- Second, FCMs must maintain written policies and procedures governing the maintenance of excess funds in customer segregated and Part 30 secured accounts. Withdrawals of 25 percent or more of excess funds in these accounts (that are not for the benefit of customers) must be pre-approved in writing by senior management and reported to the NFA; and
- Third, FCMs must make additional reports available to the NFA, including daily computations of segregated and Part 30 secured amounts, as well as twice monthly detailed information regarding the cash deposits and investments of customer funds.

CFTC Restructuring and Enforcement

The CFTC also has implemented a significant restructuring, based on a new strategic plan, regarding our oversight of SROs and intermediaries.

The CFTC last year established a new division dedicated solely to the oversight of the SROs and intermediaries. We created a branch within the division to specifically oversee examinations. We were able to attract talented individuals from the private sector with many years of relevant experience to lead this new division and branch. We have begun the process of strengthening our examination program, including adding risk and control elements. Separately, we also recently created a Consumer Outreach Office to help consumers get information about avoiding fraud.

In addition, the CFTC's enforcement arm aggressively pursues bad actors in the markets. In the last 2 years, the Division of Enforcement has been filing cases and opening investigations at the highest rate in the CFTC's history. Roughly half of the cases involve fraud against customers.

Since October 2009, the CFTC has brought 22 cases against registered FCMs, 13 of which involved supervision failures and one of which involved a failure to maintain customer secured funds properly. In the same period, the CFTC brought two cases in Federal court against FCMs, one for violating segregation rules and the other for failing to be properly capitalized and to maintain books and records.

The Commission in April charged JPMorgan Chase Bank, N.A. for unlawful handling of Lehman Brothers, Inc.'s customer segregated funds and imposed a $20 million civil monetary penalty. In another case against a public accounting firm and a CPA partner of the firm, the Commission imposed sanctions for failing to conduct proper audits of a registered FCM. In one of our supervision failure cases, a registered FCM was sanctioned for failing to follow its own compliance procedures regarding "know your customer" requirements.

Customer Protection Reforms Ahead

While the Commission's enhanced customer protection rules, staff reorganization and enforcement efforts to date have been significant, I believe we must do more. I believe we need to further enhance the agency's rules for customer protection. As outlined below, staff recommendations, based on substantial Commissioner and market participant feedback, are now drafted and in front of Commissioners.

First, we must incorporate the NFA rules approved last week into the Commission's regulations so that the CFTC can directly enforce these important reforms.

Second, I believe it is critical that we bring the regulators' view of customer accounts into the 21st century. We must give the SROs and the CFTC direct electronic access to FCMs' bank and custodial accounts for customer funds, without asking the FCMs' permission. Further, acknowledgement letters (letters acknowledging that accounts contain segregated customer funds) and confirmation letters must come directly to regulators from banks and custodians.

Third, I believe we need more transparency to customers about their funds. Futures customers, if they wish, should have access to information about how their assets are held and with whom, similar to that which is available to mutual fund and securities customers.

Fourth, I believe we need to consider enhanced controls at FCMs regarding how customer accounts are handled.

In addition, I believe we need to carefully consider additional rules laying out the SROs' requirements for conducting examinations and audits.

Regarding the Commission's oversight of SROs and intermediaries, though we're making progress through our reorganization and new rules, the recent events at Peregrine highlight the necessity of looking at the decades-old system of SROs and the Commission's role in overseeing SROs.

I have directed the CFTC's staff to do a full review of how the agency conducts oversight of the SROs, as well as limited scope reviews of FCMs, to determine what improvements can and should be made. As part of this review, we have reached out to the Public Company Accounting Oversight Board (PCAOB), which oversees the audits of public companies. The Dodd-Frank Act gave the PCAOB oversight authority over the audits of brokers and dealers who are registered with the SEC. The PCAOB has agreed to give us the benefit of its insights and expertise.

Building on the customer protection public roundtable earlier this year, I also have asked CFTC staff to hold another public roundtable discussion on customer protection issues, including examination techniques and procedures, which will take place during the 2nd week of August.

Resources

Confidence in the futures and swaps markets is dependent upon a well-funded regulator. The CFTC is a good investment of taxpayer dollars. This hardworking staff of 710 is just ten percent more than what we had at our peak in the 1990s though the futures market has grown fivefold. The CFTC also will soon be responsible for the swaps market—eight times bigger than the futures market.

The Commission's limited resources have historically not allowed for direct oversight of FCMs. There are 46 staff members, including 35 audit staff, on the CFTC's examinations team who oversee four SROs, which in turn have responsibilities for more than 4,341 registered persons. On top of the current lack of staff for examinations, our responsibilities are expanding to include reviews of many new market participants. For instance, there are currently 115 FCMs, and staff estimates a similar number of swap dealers will ultimately register. More frequent and in-depth risk-based, control-oriented examinations are necessary to assure the public that firms have adequate capital, as well as systems and procedures in place to protect customer money. Greater coverage by regulators—like having more cops on a beat—will improve the integrity and heighten the deterrent effect of the review process.

The President's FY 2013 budget, following a similar request in 2012, asked for $308 million, investing in our technology and human resources, to better protect the public.

Market participants depend on the credibility and transparency of well-regulated U.S. futures and swaps markets. Without sufficient funding for the CFTC, the nation cannot be assured that the agency can adequately oversee these markets.

Conclusion

Nearly 4 years after the financial crisis and 2 years since the passage of Dodd-Frank, the CFTC has made significant progress in implementing Congress' commonsense reforms for the swaps market.

With the foundational rules in place, it is critical that we complete the remaining reforms that will bring transparency and competition to the swaps market, lower costs for companies and their customers, and protect the public.

It is also crucial that the CFTC, working with SROs and market participants, continues its efforts to enhance protections for the funds of both futures and swaps customers.

Thank you and I look forward to your questions.

ATTACHMENT

CFTC Dodd-Frank Update

Final Rules & Guidance

- Agricultural Commodity Definition
- Agricultural Swaps
- Anti-Manipulation
- Business Affiliate Marketing and Disposal of Consumer Information
- Client Clearing Documentation, Straight Through Processing, Clearing Member Risk Management
- Commodity Options
- Commodity Pool Operators and Commodity Trading Advisors: Amendments to Compliance Obligations
- Derivatives Clearing Organization—General Provisions and Core Principles
- Designated Contract Markets—Core Principles
- End-User Exception
- External Business Conduct Standards
- Foreign Boards of Trade—Registration
- Implementation Phasing for Clearing
- Internal Business Conduct Standards (Risk Management, record-keeping, & CCOs)

- Investment Advisor Reporting on Form PF (Jt. with SEC)
- Investment of Customer Funds (Regulation 1.25)
- Large Trader Reporting for Physical Commodity Swaps
- Position Limits for Futures and Swaps
- Privacy of Consumer Financial Information
- Process for Review of Swaps for Mandatory Clearing
- Process for Rule Certifications for Registered Entities (Part 40)
- Real-Time Reporting for Swaps
- Removal of References to or Reliance on Credit Ratings
- Reporting Certain Post-Enactment Swap Transactions (IFR)
- Reporting of Historical Swaps
- Reporting Pre-Enactment Swap Transactions (IFR)
- Retail Commodity Transactions—Interpretive Guidance on "Actual Delivery"
- Retail Foreign Exchange Intermediaries—Regulations & Registration
- Retail Foreign Exchange Transactions—Conforming Amendments
- Segregation for Cleared Swaps
- Swap, Security-Based Swap, Security-Based Swap Agreement—Further Definitions (Jt. with SEC)
- Swap Data record-keeping and Reporting Requirements
- Swap Data Repositories—Core Principles, Duties & Registration
- Swap Dealers and Major Swap Participants—Registration
- Swap Dealers, Major Swap Participants, and Eligible Contract Participants—Further Definitions (Jt. with SEC)
- Whistleblowers

Proposed Rules & Guidance

- Block Rule
- Capital for Swap Dealers & Major Swap Participants
- Clearing Exemption for Cooperatives
- Clearing Requirement Determinations
- Conforming Rules
- Cross-Border Application
- DCMs—Core Principle 9
- Disruptive Trade Practices
- Governance and Conflict of Interest (DCM, DCO, & SEF)
- Identify Theft (Jt. with SEC)
- Internal Business Conduct (Documentation, Confirmation, & Portfolio Reconciliation)
- Margin for Uncleared Swaps
- Segregation for Uncleared Swaps
- Swap Data Repository Indemnification Interpretation
- Swap Execution Facilities—Core Principles, Registration, and Process for "Made Available to Trade" Determinations
- Systemically Important Clearing Organizations—Additional Provisions
- Volcker Rule

Yet to be Proposed Rules & Guidance

- Inter-Affiliate Clearing for Financial Entities
- RTO/ISO Exemptive Relief
- 201(f) Exemptive Relief
- Stress Testing under Section 165

Final Orders

- Delegation to National Futures Association (NFA)—Certain exemptions for Commodity Pool Operators
- Delegation to NFA—Foreign Exchange Intermediary Registration function
- Delegation to NFA—Swap Dealer & MSP Registration function
- Exemptive orders—Effective Date for Swaps Regulation

- Treatment of Grandfather Relief Petitions—Exempt Boards of Trade & Exempt Commercial Markets
- Treatment of Grandfather Relief Petitions—Transactions done in Reliance on 2(h)

Studies & Reports

- Feasibility of Requiring Use of Standardized Algorithmic Descriptions for Financial Derivatives (Jt. with SEC)
- International Swap Regulation (Jt. with SEC)
- Risk Management Supervision of Designated Clearing Entities (Jt. With Board of Governors of the Federal Reserve System and the SEC)
- Study on Oversight of Carbon Markets (Jt. with various other Agencies)

The CHAIRMAN. The chair wishes to thank the Chairman for those opening comments, and recognizes himself for 5 minutes.

Chairman Gensler, on February 10, 2011, in testimony before this Committee, you stated that the resource needs of the CFTC: "Given the resource needs of the CFTC, we are working very closely with self-regulatory associations like the National Futures Association to determine the duties and roles that they can take on in the swap markets. Nevertheless, the CFTC has the ultimate statutory authority and responsibility for overseeing these markets," your comments from last year. Based on this statement, is it fair to say that you and your agency take responsibility for some of what is going on in regards to customer funds at PFGBest?

Mr. GENSLER. Yes, Mr. Chairman, I think that we have to take a close look at all that the CFTC did overseeing the NFA but also the FCMs such as Peregrine in this situation.

The CHAIRMAN. Because I know your agency has been very busy on the rulemaking process, and I appreciate that. But even in the smallest town, the night watchman walks around and shakes the doorknobs to make sure they are locked, shines the flashlight through the front door to see that nothing is amiss. It just seems that perhaps in the aftermath, let us think for a moment about another one of these problems, MF Global. What should CFTC have done differently to ensure that customer funds were properly segregated in that failure?

Mr. GENSLER. I think both of these cases we have learned things. We have worked with the NFA and the Chicago Mercantile Exchange and the other SROs to put better rules in place. We were already doing this in terms of closing some of the gaps in the oversight of investment of customer funds. But we absolutely need to do more. We are also a very thinly staffed organization. We do not directly audit the futures commission merchants, and as I highlighted in that testimony you highlighted, swap dealers will be brought in as members of the NFA and directly examined by the NFA, not necessarily by the CFTC.

The CHAIRMAN. Along the topic of MF Global, did CFTC coordinate with other regulators leading up to the MF Global bankruptcy? For example, did you consult with the Financial Industry Regulatory Authority and SEC when they forced MF Global to change their capital treatment of its foreign sovereign debt position?

Mr. GENSLER. Mr. Chairman, I can speak about what I was personally involved in, but as I am not involved in the MF Global matter, but over that weekend as it——

The CHAIRMAN. Speak to the point in time up until which you recused yourself.

Mr. GENSLER. That is what I will do. Over that weekend, as the MF Global events transpired and we at the CFTC were working to try to move customer funds. We did work with the SEC, with FINRA and with the international regulators in London, the Financial Services Authority.

The CHAIRMAN. Let us touch on LIBOR for just a moment. I asked the Federal Reserve Chairman, Ben Bernanke, last week when the Fed first heard about the possibility of LIBOR manipulation. He told me in a Financial Services hearing that he first learned about it in 2008 and that the Federal Reserve briefed other Federal agencies at that time including CFTC. Chairman Gensler, why is it that the LIBOR manipulation was able to continue at Barclays in 2009?

Mr. GENSLER. We at the CFTC started and opened an investigation in April of 2008 based on news reports in *The Wall Street Journal, Financial Times,* and elsewhere. That investigation culminated in what you learned of a few weeks ago.

The CHAIRMAN. But isn't it true that Barclays also self-reported the derivatives manipulation and it really wasn't the CFTC that discovered it, it is when they admitted it, and what does that say about the ability of regulators to discover wrongdoing? I suppose that is the bottom line, Chairman.

Mr. GENSLER. Well, the bottom line is that CFTC worked and reached out to law enforcement agencies in London, the FSA, and the Justice Department to develop this case. It is a very pervasive action that Barclays was involved in involving two regs, three cities, 4 years of misconduct on the part of Barclays, and involving senior management. So the CFTC reached out and developed the evidence also over two continents and different jurisdictions.

The CHAIRMAN. It just seems, Chairman—and my time has expired—from the country perspective, we spent a lot of time putting up street signs but we haven't rattled enough doorknobs lately.

I now recognize the Ranking Member for 5 minutes.

Mr. PETERSON. Thank you, Mr. Chairman.

I would like to follow up on this LIBOR situation. So you were investigating it. Did any of the other regulators contact you about this or were they working on it, or were you guys doing this by yourself?

Mr. GENSLER. I am aware and we are aware that in June of 2008, and the New York Federal Reserve has put this on their website, that there was a report to an interagency staff group about LIBOR—it is called the President's Working Group—that laid out some of the general concerns that the New York Fed had in June. But in terms of the law enforcement action, actually pursuing infractions of the Commodity Exchange Act of false reporting and attempting to manipulate this rate, that is something the CFTC did with other law enforcement agencies and took a long time to develop those facts and get evidence, hard evidence to take to court or to get Barclays to settle.

Mr. PETERSON. So these other folks, they didn't have any reason or any business to be investigating this, the Fed?

Mr. GENSLER. I can only speak to the CFTC, but we reached out to law enforcement agencies to the SEC and the Justice Department and the Financial Services Authority, which have law enforcement and the Financial Services Authority——

Mr. PETERSON. So you guys were all working together?

Mr. GENSLER. Yes. The Financial Services Authority initially was facilitating our document requests and information requests. They subsequently opened a live investigation, which they publicly said was in 2010.

Mr. PETERSON. There were reports in *Barron's* in July of 2012 that the CME heard complaints from traders about the LIBOR rate, and I guess they went as far as contacting the British Bankers Association regarding these complaints. Did the CFTC ever receive any expression of concern about possible fraud manipulation or problems about LIBOR from CME?

Mr. GENSLER. I am aware that our staff knew that there were conversations, and it may have even been in the press at the time between the CME and the British Bankers Association. But in terms of actually developing a case with hard facts and evidence of manipulation or false reporting, that was done directly with law enforcement agencies, shaking the doorknobs, as the Chairman said.

Mr. PETERSON. I understand, but I guess what I am getting at is that I think you guys did the right thing. You went in, following the law and developing the case and all that stuff, but these other folks that are affected by this—and this was in the press—were they concerned about this? Did they ask questions? Did they know what you were doing and were they satisfied with that? Why weren't they concerned for 4 years that this potentially was a problem? That is what I don't get. I understand what you are doing, but I mean, the people that are affected by this, weren't they concerned about this?

Mr. GENSLER. Well, those are very important questions. I can tell you that law enforcement agencies, once we actually brought something real and actionable with evidence to the Justice Department, they were terrific, the FSA when they opened their live investigation, and we were rattling those doorknobs for quite some time to make sure. This market is so critical to borrowers and lenders in this country.

Mr. PETERSON. That is my point. So why weren't the borrowers and lenders screaming about this for 4 years, or didn't they know what was going on, or didn't they care?

Mr. GENSLER. There were academic reports, there were news reports, and I think that as I said earlier, that the market has become less and less transaction-based and more estimate-based. This interbank borrowing market had—as Mervin King said in the fall of 2008, LIBOR is the rate at which banks aren't lending to each other. Our career staff, well before I got there, sir, started to focus on this. It takes a long time to build a case that you can take to court.

Mr. PETERSON. I don't understand enough about this to know, but it just seems to me that if these folks, that if everybody knew about this and nobody said anything, apparently it must have been benefiting them so they were just happy to have it continue. It is another case where these guys, the whole damn system is set up to benefit Wall Street and nobody else in this country. I am tired of this. You just wonder where these people are, and we commend you for what you do and working on this. We have a system that is so complicated that it takes you 4 years to nail it down. That tells you something right there.

The CHAIRMAN. The gentleman's time has expired. The chair now recognizes the gentleman from Texas, Mr. Neugebauer, for 5 minutes.

Mr. NEUGEBAUER. Thank you, Chairman Gensler, for being here this morning. Prior to the April 2008 *Wall Street Journal* article, your agency didn't have any knowledge that there were concerns about LIBOR? Is that your testimony?

Mr. GENSLER. We opened an investigation in April of 2008. In talking to some of the career staff, I wasn't there then, but in talking to them, they were aware of some of the academic and some of the news stories but it was that *Wall Street Journal* piece that they decided to open what is a live investigation into these matters.

Mr. NEUGEBAUER. So you weren't aware that as early as the latter part of 2007 that people at the Federal Reserve Bank in New York were made aware that there could be some problems with LIBOR? You didn't ever have any notice from the New York Fed of that?

Mr. GENSLER. Congressman, we haven't gone back to do forensics, but sitting here today, I am not aware that our staff was made aware of anything except for the news stories and academic research by April.

Mr. NEUGEBAUER. But it was the *Wall Street Journal* 2008 article that kind of triggered the opening of a case in your organization?

Mr. GENSLER. That is right, and it was actually reviewed with Commissioners in late April. We have an every-Friday surveillance meeting with the surveillance team, and the enforcement folks talked to Commissioners in April of 2008.

Mr. NEUGEBAUER. Chairman Bernanke was here last week, and one of the things I asked him is, can one bank—I think there are 16 U.S. Dollar LIBOR banks that report to make up that index—could one bank alone influence that rate, and his response was that no. I think you have in your report or in your findings alluded that there are other banks involved or other banks that are under investigation at this time. Is that in fact, other banks are going under the same investigation that you did with Barclays?

Mr. GENSLER. I am going to try not to compromise an ongoing enforcement matter, but what we said in the Barclays situation was that in the case of Euribor, that there were four other banks that Barclays was aiding and abetting. That means that Barclays was trying to assist them but they were also asking these other four banks, which we called bank A, B, C and D, to assist Barclays in the setting of Euribor for the profits of their desk. But I might also add that in the Department of Justice findings and order, Barclays admitted—I can even give you the paragraph, 30—that in some occasions their manipulation of their submissions did affect the rate, and that is in the Barclays order with the Department of Justice.

Mr. NEUGEBAUER. But it would be difficult for one bank to do that on its own. Would you agree?

Mr. GENSLER. Though in the Department of Justice findings and settlement with Barclays, they did say that on some occasions it did affect it, because even a basis point averaged, to walk back for the Committee, 16 banks submit. Four low ones and four high ones are thrown out. The eight middle ones are averaged. Even one bank could possibly affect on some days.

Mr. NEUGEBAUER. So just the bottom line, but there will be other findings from the CFTC on this issue. Is that your testimony?

Mr. GENSLER. Again, not to compromise any ongoing enforcement matter, we are going to vigorously pursue enforcement matters around these benchmark rates. These rates need to be reliable but it is also the law. The law is, don't false report, don't attempt to manipulate or manipulate these rates.

Mr. NEUGEBAUER. I want to go back to Peregrine for just a minute. I think we are reading that one person was evidently falsifying a tremendous number of documents, daily reports, financial statements, bank statements, bank verifications. I mean, the list goes on and on. And so either we have a very unsophisticated regulatory structure or this was a very sophisticated gentleman that could carry off for as long a period of time as he did this fraud. I would hope, and we are going to hear today hopefully that we are going to have to jack our surveillance up, that if one person—and I don't believe one person could actually have pulled this off—but one person could defraud a fairly broad number of regulators that are supposed to be looking after on behalf of the customers of these institutions. So I am hopeful that we are going to hear some very positive steps but it doesn't speak well when one person can pull that off for that period of time.

Mr. GENSLER. I share our view that we have to up our auditing oversight both at the CFTC and the self-regulators, and I also would say, we don't know all the facts yet. There is going to be a lot more that we learn about the facts of this situation.

Mr. NEUGEBAUER. Thank you, Mr. Chairman.

The CHAIRMAN. The gentleman's time has expired. The chair recognizes the gentleman from Iowa for 5 minutes, Mr. Boswell.

Mr. BOSWELL. Thank you, Mr. Chairman.

Thank you, Mr. Chairman Gensler, for being here to talk to us. Listening to what has been already said, yesterday or recently we also had some discussions with the NFA personnel and so on, and understand how they structure their toolbox to do their work, 2¢ per trade on both the borrower and the seller and so on. I understand that, and with that, they have managed to add about 25 percent annually to their toolbox, if you will. After the collapse of Wall Street, we passed Dodd-Frank, which I have always felt like would probably need some tweaking and I have no quarrel with that, but we expanded the CFTC's responsibilities regarding oversight. Then we discovered the collapse of MF Global last October, made it apparent that we must provide our oversight bodies with tools.

So I want to ask you this question. Do you think that the structure similar to the way we fund the SEC would benefit the CFTC based on a general growth rate? How do the investments of technology made by CFTC compare to those made by the SROs?

But before you answer that, I would just say to Mr. Conaway and Mr. Lucas, I respect you guys very much. There is probably nobody in the room that has spent more time where you come from than I have. As a young man, I went to a place west of Odessa named Monahan. I was out there in an oil field—just a young farm kid who was willing to do hard work—and they hired me to substitute so everybody could take vacation on the drilling rig. I did all the jobs—lee tongs, backups, tower, mud mixer—I did it all. And then later on I spent time in mineral wells, Fort Walters, a couple trips, Fort Bliss, Oklahoma, I am practically an Okie. Fort Sill, I have been there a lot of times, and so on. I was interested in what happens out there in agriculture and realized over the years that the technology has changed so much for farmers because of the intensity of capital invested. They have to be able to have marketing tools.

And so we went through all this. Thank you, Mr. Peterson, for what you said about what is going on here and what are we going to do? I am not sure where—and I say this very respectfully: maybe we need to talk about this outside the room but where are you leading us to deal with this? Because I am ready to follow if I understand it, and I know I sat over there in the chair when we—after Dodd-Frank I was Chairman and I have now been Ranking Member with Mike, and I appreciate that. Maybe you can tell me, where are you trying to take us on this. I would like to know. Because we have a heavy responsibility. I want to help. I think we need tools. I guess you have combined a little wheat and you have certainly pulled a few calves, same as I, and so on. I could never go to the field even with a modern combine without a toolbox. I am not too sure that you have the toolbox. So I hope you can answer that. But I don't know. I would yield to anybody to help me out. I am kind of like you, Mr. Peterson. Where are we going and how are we going to get on top of this? Because if we need to tweak Dodd-Frank, let us do it, but let us not give them responsibility to do what we ask them to do and then say whoops, figure out some way to do it on your own.

I yield.

The CHAIRMAN. I thank the gentleman for yielding.

I think we are in the process now of what has been a multi-year effort. The Chairman regularly alludes to the fact that he is in the process of fulfilling all of his rulemaking responsibility under Dodd-Frank, has not completed that yet but is in the process.

Mr. BOSWELL. But we still keep trying to take his resources away by cutting his budget.

The CHAIRMAN. I think we have a responsibility on this Committee—we are not appropriators, we are authorizers—to provide oversight to make sure that the Chairman and his Commission are fulfilling the spirit of the law as well as the letter of law. All of that in addition to their mandated responsibilities under Dodd-Frank, they are fulfilling all the other responsibilities that are ongoing with this process. I used the country phrase about the night watchman shaking the doorknobs in referencing to that as well as putting up stop signs or street signs. I understand the Chairman has a difficult challenge but we also have a responsibility to provide oversight, to verify that he is following the rules, that he is doing what he needs to do. If he should deviate from the intent of the law, our responsibility is to guide him back to that point and to help move him forward. If there were indeed flaws in the law or flaws in the rule—I know what would surprise the Chairman to hear there might be a flaw in the rule somewhere—if there are flaws, then it is our responsibility to bring attention to that to help make sure changes can be made.

Right now in the legislative environment we are working in, it is kind of challenging, as my good friend from Iowa knows, to get much of anything done. That is just the lay of the land as we face it. That is why we worked so hard the other night on a markup on a comprehensive farm bill.

Mr. BOSWELL. You did a good job.

The CHAIRMAN. That is what my main focus is and yours too, my good friend.

Mr. BOSWELL. Absolutely.

The CHAIRMAN. But we are going to fulfill our responsibilities. We are going to move this process forward and our friends are going to work doubly hard, I am sure, to fulfill their responsibilities.

Mr. BOSWELL. Thank you very much. I appreciate that, and I like your analogy of shaking the doorknobs. I think it is kind of linked up with having the tools in the toolbox. Okay. I went past my time. I will yield back. You take all the time you want.

The CHAIRMAN. I would say to my good friend, all of our time has expired, and now I turn to the gentleman from Texas, Mr. Conaway, for 5 minutes.

Mr. CONAWAY. Thank you, Mr. Chairman. I appreciate the comments from Mr. Boswell.

Chairman Gensler, thank you for the call the other day. We have a target-rich environment this morning for questions on the array of things that are in front of your Commission, but I want to talk about the extraterritorial guidance. I appreciate your call the other day and our conversation about that. I now know some more about it that I didn't know then, and some questions have just come up to me, so I am not saving these for you, I just didn't think about them at that point in time.

This fits in the foundational kind of rules that some would argue require you to work with the SEC to put this rule or guidance, whatever we wind up calling it, in place. SEC has said they don't have the authority to issue guidance the same way that the CFTC did. Can you walk us through how you came to conclude this and why this isn't more coordinated with the SEC? Quickly, because I have a series of questions on this issue.

Mr. GENSLER. First, I would say I now have come to use the word *cross border* because I can pronounce it, but on the cross-border issues, we do have a provision in Dodd-Frank that was not placed in the SEC's side of it. It is section 722(d). What it says specifically is, we are not to regulate something unless it has direct and significant effect on the commerce or activity of the United States. Those words that are in Dodd-Frank are on our side, not the SEC's. And we received a lot of questions from many, many market participants: what do those words mean, can you interpret those words. Congress didn't say we shall do a rule or anything.

Mr. CONAWAY. Okay.

Mr. GENSLER. So we are trying to interpret those words and leave some flexibility, frankly, that it is not as rigid.

Mr. CONAWAY. In that regard then, where does guidance fall in the pecking order? If I am a cross-border firm and trying to look at this guidance and it is open for comment for some 45 day period, so the guidance is not even final, I have a 60 day clock, soon to start running with respect to swap-dealer registration and I am going to make real-world decisions to spend money and to reflect that guidance. Are you expecting folks to comply with this as if it were a rule?

Mr. GENSLER. So we have also put out at the same time for 30 day public comment something about phased compliance or an exemption for 1 year for these foreign-based swap dealers from many of the rules of Dodd-Frank—the entity-based rules. They would have to comply with transaction-based rules that are in effect like real-time reporting if they are doing something with a company in Texas. So if a bank in France was doing a trade with somebody in Texas, that would still have to come——

Mr. CONAWAY. Under the transaction rule but not the entity itself would——

Mr. GENSLER. That is correct.

Mr. CONAWAY. And do you expect working with your friends at the SEC that they will come to similar conclusions when they go through their actual rulemaking process on this?

Mr. GENSLER. I think they will be similar but not identical because again Congress did something different on their side of the statute than ours so that——

Mr. CONAWAY. Well, that seems to be the cart driving the horse. In other words, what we want is regulations that work for everybody and allows them to comply. I haven't harassed you too much about the end run on cost-benefit analysis that this guidance proposal appears to allow you to not do cost-benefit analysis of what compliance under these guidance rules might cost and what those benefits are. But the idea is that they ought to be parallel with the SEC and not rely on a flawed law that Mr. Boswell said we probably need to fix some of that kind of stuff, but the idea is, then you would be able to comply with this and not let the law drive a goofy answer.

Mr. GENSLER. The SEC, the Treasury and the Federal Reserve have all given us advice and counsel for many months on this document we put out to public comment, and I believe we will be close whenever the SEC moves forward, but again, because they have different statutory framework, there will be some difference.

Mr. CONAWAY. Let me ask in a similar vein, Barclays, which you guys did a good job and I was hoping you would brag more on your team this morning about that because I do think you did a good job. But the agreement that you made with Barclays Bank sets in place some things that they will now do with respect to their operations. Will that now become the industry standard for everybody else and is this another way to get at a rule without going through the normal rulemaking processes that we generally have put in place?

Mr. GENSLER. Let me first brag on the team, Vince McGonagle and Gretchen Lowe, Anne Termine, and David Meister, I mean, fabulous, tough, tough case, fabulous work they have done.

In terms, yes, we had Barclays commit that as they make these submissions in the future, they have to be transaction-based, focused on Barclays transactions, and if there aren't transactions in this unsecured market, they have to look to their secured borrowings. They have to have firewalls and——

Mr. CONAWAY. That is fine, but I really wanted to focus on the impact this has on the rulemaking process. In other words, will you use this again in the future with legal operations to get at a backdoor rule for everybody else?

Mr. GENSLER. I now understand your question. We were really focused on Barclays. I mean, Barclays had such pervasive activity that was not in compliance with the law, so pervasive we said no, you have to have these undertakings. We have undertakings in many of our settlements. They just don't get as much publicity as this here. And I would say that just as in other cases, people should read those undertakings and understand them but they are Barclays specific.

Mr. CONAWAY. You mentioned the PCAOB helping you with auditing standards. They set the auditing standards for public companies. I would also refer you to the AICPA, which sets auditing standards for private companies, and the fellow that I suspect was auditing Peregrine was likely not registered under the PCAOB.

Mr. GENSLER. I think that is very good advice. I think that they were registered but it is still very good advice.

Mr. CONAWAY. Thank you, Mr. Chairman.

The CHAIRMAN. The gentleman's time has expired. The chair now recognizes the gentleman from North Carolina, Mr. Kissell, for 5 minutes.

Mr. KISSELL. Thank you, Mr. Chairman.

Thank you, Chairman Gensler, for being here with us today. We had a hearing a while back on MF Global; and as Members of the Committee were questioning board members, Commissioners from the CFTC about some of the oversight things, it was pointed out, I believe by the Ranking Member, that MF Global had really transitioned from a commodities-based firm to a securities firm and really at that point in time when some of the bad things happened, it was more of an SEC responsibility than a CFTC responsibility.

In that regard in that transition, and somewhat in follow-up to Mr. Conaway's questions, as the CFTC moves forward in its definitions and its rulemakings, and as the comment time closes, and looking at the cross-border aspects of some things, some folks had come to me and talked about, they were concerned not wanting changes in laws and regulations, just looking for certainty, and they were concerned if you guys finished your work too much in advance of the SEC doing the same things. Looking at MF Global as an example of a company that switched, in between, are you concerned that if you get too far ahead of the SEC if there might be the gaps in there that might create problems in oversight, in the paperwork, in compliance issues if there is too much of a gap between these things being done? I just wonder what your thoughts are.

Mr. GENSLER. I am mostly concerned that 2 years into this and 4 years from the crisis we need to get these common-sense rules of the road and the traffic lights in place. The timing gap with the SEC, they are overseeing the securities-based swaps, which is a much smaller part of the market, does raise some concerns in clearing of credit default swaps, so that is something we have looked at very closely, especially the largest clearinghouse, the IntercontinentalExchange. I would hope that we could get portfolio margining, which is a very detailed issue, done, because that we need to do with the SEC.

The timing gap that is probably more significant is with Europe and with the international regulators and this cross-border issue, and that in part is a significant reason why we gave this 1 year period to sort through some of these international issues. We have a proposed exemption for another year on the international side.

Mr. KISSELL. Thank you, Mr. Chairman, once again for being here and I yield back my time.

The CHAIRMAN. The gentleman yields back. The chair now recognizes the gentleman from Colorado, Mr. Tipton, for 5 minutes.

Mr. TIPTON. Thank you, Mr. Chairman. Thank you, Chairman Gensler, for being here as well.

I think that I would like to follow up a little bit on what Mr. Conaway and Mr. Kissell have been talking about in regards to some of the cost-benefit analysis of this. Our counterparts seem to have pretty much the same conversation, which is financial certainty in terms of what is being proposed by the CFTC. You have issued but not published in final form a number of rules that are going on. When we are talking in country, not extraterritorial, but in country on the proposed rules, are you expecting compliance because that seems to still be fluid, and some of the costs that are going to be associated from these various groups that they are going to have to try and comply and then change as that rulemaking process has not been finalized.

Mr. GENSLER. To answer your question, no, and we have been very clear and issued exemptive language. We are hopeful to get our proposals finalized by the end of this year. We have granted relief through the end of the year, and then as we finalize those we would put in place compliance schedules well into 2013 for the rules that might be finalized later this year. But only the final rules that are in place are actionable and enforceable.

Mr. TIPTON. Great. And one thing I would like you to maybe explain just a little more on, whenever there is a problem, we all want to make sure that the markets work well, people are held accountable, the people's resources are sound and we can count on the information. You had commented that are you doing some internal examination, that you stated in your testimony the system failed to protect Peregrine's customers, and that we need to take a close look at how the CFTC handled its oversight. Are you identifying, *in lieu of* new rules, where it failed internally and how to organizationally make this work better?

Mr. GENSLER. We are doing that. We had already restructured this group, the examination function and oversight of the self-regulatory functions and hired a new head of examinations and also a new head on top of that, but that is not enough. I mean, they are terrific people but we really do look at this and say we have to do better. How do we, in essence, audit the auditors, how do we examine the SROs, because that front line of defense is embedded in statute? That is what we have had for decades. Now, how do we enhance that front-line defense and then the CFTC's responsibilities? As the Chairman says, we ultimately do have that responsibility and should be held accountable to make sure we look internally how we can do this better.

Mr. TIPTON. You know, and I think we probably agree, the majority of the players want to make sure that things are done properly and abiding by the law that is going on, but when it got into the extraterritorial rulemaking, the five Commissioners went ahead and moved through without the customary input for public comment. Moving on, you have now opened this up for 45 days. Do you think that is a prudent thing to do or would it be better maybe to talk to people that are actually in the business to be able to seek some guidance in terms of how to make sure that the rulemaking process moves forward for that interaction with the SEC as well?

Mr. GENSLER. Well, Congressman, with all due respect, we had gotten a lot of input from market participants, and we list those meetings on our schedule, but I would have no doubt there were dozens of meetings and dozens of letters from commenters, if not over 100 letters from commenters, about the cross-border application, and then we put that in this interpretation and the relief, the 1 year relief I referred to. We had input from the SEC before we did that and now we are going to get further public comment on that because it is critical to get the public comment.

But I would say that if we followed the industry's approach completely, they would move the jobs and the markets to London or the Cayman Islands or somewhere but the risk still comes crashing back here. AIG Financial Products, that was located in Mayfair in London. Citicorp's special purpose vehicles, their off-balance-sheet vehicles, were originated in London and incorporated in the Caymans. I could go crisis by crisis. The risks come crashing back to the American public and so we think that when Congress said to oversee what is direct and significant that we have to find a way to make sure those branches and affiliates of U.S. financial parties have in place some common-sense transparency and risk-reducing rules.

Mr. TIPTON. I see my time has expired. Thank you, Mr. Chairman. I yield back.

The CHAIRMAN. The gentleman's time has expired. The chair now recognizes the gentlelady from Maine for 5 minutes, Ms. Pingree.

Ms. PINGREE. Thank you very much, Mr. Chairman, and thank you for being here with us today.

I am going to ask a slightly different question but it is on the same perspective of all the work that you are doing. There was a lot of attention this morning to the fact that Sandy Weill was, I guess, on CNBC and it has been covered in *The New York Times* so obviously the former chair of Citigroup, and one of his very thoughtful comments was that the big banks should be broken up into separate commercial banking and investment entities. So given his perspective, and obviously this is a clear change of opinion of himself and probably a lot of other people out there, how does that affect your view of the current Volcker Rule? Do you think maybe now we should be thinking about a more robust version as we are going through this process?

Mr. GENSLER. There is a lot in that question.

Ms. PINGREE. That is okay. I have 5 minutes.

Mr. CHAIRMAN. And you tend to put a lot back in your answers.

Mr. GENSLER. I think we need common-sense rules of the road so that if a bank fails, there is a freedom to fail, that the taxpayers are not standing behind banks. I think that has got to be the heart of what we do in the derivatives regulations and otherwise in Dodd-Frank. I think in terms of the Volcker Rule, the approach Congress took is to lower some of the risk of this proprietary trading but of course at the same time still permit very important market-making and risk-reducing hedging. It is probably one of the most challenging rules in front of regulators, how to prohibit proprietary trading but permit these important activities, market making and hedging.

Ms. PINGREE. I know you are going to give a longer answer but I am going to just interject for a second because this is part of my follow-up question. In previous hearings, we have heard some people question whether you can make the distinction between a hedge or a proprietary trade, so actually I was going to ask you a little deeper on that and maybe you could at the same point comment about how you define it, have we gone far enough. If certain other bankers are thinking it is still too confusing, are we going far enough?

Mr. GENSLER. I think it is a challenge for regulators. I think Congress was clear that you can hedge specific risk, whether it is a specific position or an aggregate position. Congress decided that. But I don't think that Congress meant by that that it could just be, well, I am going to say this table here is a hedge. You see, I am just telling you this is a hedge and therefore it is hedge. It is hedging something. And it has to have reasonable relationship to the underlying positions, and I think that is the challenge. The JPMorgan Chase situation on credit derivatives and portfolio hedging, we have to learn from that and think about that. When is portfolio hedging really related to specific risks and when is it something that is mutating into just betting on the markets.

Ms. PINGREE. So are you imagining that portfolio hedging will somehow stay in the final rule?

Mr. GENSLER. Well, Congress already spoke to that, that it could be hedging aggregate risk of positions. My own experience when I was on Wall Street, that when you separate a hedge further and further from a trading desk and it has a separate profit-and-loss statement and separate managers, it tends to mutate into something else, but if it is actually related to aggregate positions and has a reasonable correlation to that, for instance, it loses monies when the positions make money and it makes money when the positions lose money, that probably tells you it is a real hedge. But otherwise it might be something else and Congress said let us lower that, let us prohibit that, in fact.

Ms. PINGREE. So I am not an expert in this field, but given how confusing that is, and if certain bankers are already saying it is confusing, why doesn't it make us want to go back and look at the

Volcker Rule and say, "Well, let us just go back to keeping them completely separate." Maybe it is not going far enough to have a really complex, difficult-to-enforce and difficult-to-understand rule, why not on the Volcker Rule do what Sandy Weill said, "After years of history now looking back, we ought to just break up the banks?"

Mr. GENSLER. I am not familiar exactly with what he said this morning, but of course, that is part of what Congress debated and can debate in the future. We would work with you in any way on that.

The CHAIRMAN. If the gentlelady would yield?

Ms. PINGREE. Yes.

The CHAIRMAN. I think you are referencing that traditional separation of the two that was put in place in the 1930s under Glass-Steagall. There is much discussion about that, yes. I yield back.

Ms. PINGREE. And for the record, I am in favor of Glass-Steagall and going back into that position, and you are right, I can't paraphrase him or anyone else, but it seems to me given some of the confusion around the complex way we are trying to make them separate but not, we should reinstate Glass-Steagall. Thank you.

Mr. GENSLER. I think the critical piece is that if any of these banks fail we not stand behind them.

The CHAIRMAN. The gentlelady's time has expired. The chair now recognizes the gentleman from Florida, Mr. Southerland, for 5 minutes.

Mr. SOUTHERLAND. Thank you, Mr. Chairman, and Mr. Gensler, thank you for appearing before us today.

I have a couple questions. I wanted to read a little bit of information from—this is PFGBest customer account agreement that they sent to all of their customers. It says "If your securities futures positions are carried in a futures account, they must be segregated from the brokerage firm's own funds and cannot be borrowed or otherwise used for the firm's own purposes. If the funds are deposited with another entity, (*e.g.,* a bank, a clearing broker or a clearing organization) that entity must acknowledge that the funds belong to the customer and cannot be used to satisfy the firm's debt," and I would like, Mr. Chairman, to incorporate PFGBest *Customer Account Agreement* into the record.

The CHAIRMAN. Seeing no objection, so ordered.

[The information referred to is located on p. 110.]

Mr. SOUTHERLAND. So my question is, obviously there is proof that that was violated, I am curious, how do—why didn't CFTC monitor segregated funds and secured accounts held by JPMorgan Chase, who obviously knows that rule. There didn't seem to be a paper trail to prove that those funds were held in the account as they were supposed to be and that a proper usage of a withdrawal was proven before they released those funds.

Mr. GENSLER. If I understand the question, why wouldn't a bank have done that? We are going to learn a lot more facts but there are a number of points of outside auditors, self-regulatory organizations like the NFA auditing and, yes, even the CFTC doing some limited-scope reviews. Acknowledgement letters, you referred to acknowledgement letters, may have been forged here as well so that it looks like from Russ Wasendorf's own words and his note found when he attempted to kill himself was that he was using PowerPoint to forge bank statements as well as some of these acknowledgement letters and confirmation letters. All of the points of protection—outside auditors, NFA, even our limited-scope reviews—did not find this. The system let down these investors. But I believe acknowledgement letters, confirmation letters, bank statements and custodial statements should be directly electronically available to the regulatory agencies. We are working with the NFA and the CME to try to get that in place shortly.

Mr. SOUTHERLAND. But it just seems to me that if JPMorgan Chase released these funds, they had a burden to confirm—and I understand what you are saying, that there were forged documents, but oftentimes many of the American people sometimes feel that investigators, bureaucrats, and many times regulators couldn't track an elephant in the snow, and when you look at this right here, I think that warrants their feelings.

I want to say I know I am running out of time but I want to ask you this: Unlike stocks, future trades are not covered under the Securities Investor Protection Corporation, SIPC, which protects against losses from unauthorized transactions up to $500,000, or $250,000 limit for cash. Why shouldn't these futures be covered by SIPC as insurance protection for really honest investors who in good faith have made those investments?

Mr. GENSLER. Well, that is a debate that has come about. Commissioner Chilton, one of my fellow Commissioners, has recommended it, and I know that you will be considering that. I would say there are costs and benefits, and what we need to do at the CFTC is not frankly wait for that but really put in place stronger protections around these accounts, even building on what we have already done because we have done a lot to put in place further protections as that debate goes on.

Mr. SOUTHERLAND. Well, and I think that right now we are doing forensics. It would be nice—you made reference to your grandfather—my mom raised me on plenty of anecdotes too and she always said to me, an ounce of prevention is better than a pound of cure. I would encourage to look at how we can better protect our investors.

And the last thing I would say, Mama also told me—and by the way, being a Member of Congress and the older I get, the more I realize my mom and dad were pretty smart—my mom would always say, if you wallow with the hogs, you are going to get dirty, and might I suggest that we monitor the hogs that Mr. Wasendorf wallowed with? You might find some other dirty hogs. I yield back.

The CHAIRMAN. The gentleman's time has expired on that thought. The chair now recognizes the gentleman from Vermont for 5 minutes, Mr. Welch.

Mr. WELCH. Thank you very much.

Mr. Gensler, a couple of things. Number one, good job, and I do hope that we adequately fund you. Much is being expected, and if you are going to do what is required in order to maintain the credibility of the futures market—we are going to have gentlemen and women testifying after you who are using that market for the purposes for which it is intended—we have to give you the resources. So I support full funding for your efforts.

I want to ask you about derivatives and a little bit about what happened with JPMorgan Chase. One of your predecessors, James Stone from Massachusetts, wrote an article recently, and he pointed out that JPMorgan had, as many banks do, a huge exposure of derivatives notional value contracts. In the case of JPMorgan, it is about $75 trillion. That is an enormous outsize risk. And the question that I asked myself and he asked as well: are there regulations really that we can constantly be cooking up that somehow keep up with the level of risk and the level of creativity in the derivatives markets, or is it time to make some requirement that there be some money on the table from the big banks when they are putting so much of their shareholder and depositor money at risk and where obviously it has implications for the economy?

Just to go through a few of the things that he pointed out, the risk is disconnected, as you were saying earlier, from the actual trading desk. I don't think that is true with folks who are going to be testifying next. There is a direct connection between what they are doing and how they are trying to offset that risk, and we support that. But where the three largest banks have 24,000 percent notional value risk compared to their assets, any deviation in their risk model where there may be a black swan, as they call it, where there may be a geopolitical event, 1⁄10 of 1 percent is going to have a big exposure.

Now, rather than doing all these rules and regulations, we are having fights about it that get reflected in our squeezing your budget because we can't come to some understanding, one of the things that Mr. Stone recommended is that those banks or those derivative players would have to put down 1⁄10 of 1 percent to offset that risk, and it means that the taxpayers may not be exposed. Seventy-five trillion dollars of notional value would be $75 billion in cash money that would be a factor that would reduce that counterparty risk, reduce the trading volumes and bring us back to what had been historically the purpose of the futures market and hedging, which is to offset.

So rather than all this complicated regulation where I am starting to get to the view that my colleague here from Maine had that some of these institutions are too big to fail, they are too big to regulate as well, what would be your position about requiring that there be some exposure with a 1⁄10 of 1 percent just for discussion purposes on these derivatives contracts?

Mr. GENSLER. I actually think that is what Congress did in the Dodd-Frank Act by saying that the standard derivatives have to come into a clearinghouse, so clearinghouses collect margin, and that the non-standard contracts the banks have to collect margin, not on the non-financials, the end-users are out of this, but for the 90+ percent of the market that is insurance companies and banks and hedge funds, that they have to put up margin at the clearinghouses, put up margin. If they fail, that is money in the game, skin in the game that they can unwind that position and hopefully the taxpayers, the clearinghouse is not held to account. It is the JPMorgan that would lose in that circumstance. And so you did that actually. The question is whether, you might say, is it enough.

Mr. WELCH. And in your view, is it?

Mr. GENSLER. Well, I think that we put out very strong rules about the amount of margin that has to be at the clearinghouses. We haven't finalized the rule on the margin for the uncleared swaps. We are working internationally. We don't want to do it ahead of Europe. This is one where we want to time this with Europe around the end of this year or the first quarter of 2013. But yes, you should hold us accountable that there is enough in the uncleared swaps because you wouldn't want risk to go there inadvertently.

Mr. WELCH. Thank you.

The CHAIRMAN. The gentleman's time has expired. The chair now recognizes the gentleman from Illinois, Mr. Hultgren, for 5 minutes.

Mr. HULTGREN. Thank you, Mr. Chairman.

Thank you, Chairman Gensler, for being with us today. A couple questions. Yesterday, CFTC published an initial list of swaps proposed to be subject to the clearing mandate. It appears that Europe will not be prepared to have any such clearing mandate in effect until 2013. What is the expected timing in Asia for an enforceable mandate clearing requirement?

Mr. GENSLER. Japan is a little ahead of us actually. They were targeting November of this year to have their mandate in place. Hong Kong and Singapore will be later, though, so Japan is a little ahead of us, Hong Kong and Singapore later.

Mr. HULTGREN. What effect do you expect the timing of these mandates will have since they are not coordinated?

Mr. GENSLER. Well, I think that it will lower the risk to the American public, and that is what we have been chatting about here, but it would only be a mandate on transactions that have a direct and significant effect on U.S. commerce or activity, so it is with U.S. persons. We phased in compliance. We said for 1 year, for instance, even if you are a large American bank and you operating out of Frankfurt and you are operating with some German insurance company, that mandate doesn't apply there. It is back to U.S. persons and direct and significant effect back here in the United States.

Mr. HULTGREN. Let me ask you briefly just about some of the cross-border guidance proposal that CFTC put together to inform market participants and end-users about the extent of overseas reach of U.S. derivatives regulations. I wondered why the CFTC chose to address this important issue via guidance rather than through a formal rulemaking. My concern is, by doing so, you essentially avoid cost-benefit requirements associated with a formal rulemaking. Did you take into account the cost of imposing and enforcing CFTC rules overseas?

Mr. GENSLER. To your last point, the cost of not putting them in place is another crisis. Risk comes back to our shores and the jobs are overseas. I mean, let me just talk about American jobs. They will move to London, they will move elsewhere where somebody thinks the regulation is lighter. Having worked at a large investment bank with hundreds of legal entities, you just pop another legal entity somewhere across the globe but the risk still comes back here in a crisis, so we did consider that. The reason we did interpretation is because there are legal words in the statute that a lot of people said can you interpret them, section 722(d), and so we are trying to interpret them but maintain some flexibility as well because each legal entity is going to have different facts and circumstances.

Mr. HULTGREN. Under Dodd-Frank, Congress required CFTC and SEC to jointly adopt foundational derivative rules such as those defining swap and swap dealer. Clearly, Congress expressed its intent that the rules governing the scope of the entities and products subject to Title VII should be defined by those two regulators in concert. In my view, the cross-border guidance is effectively part of that *swap* and *swap dealer* definitional rules. You can't know what a swap or swap dealer is without clearly understanding how cross-border issues are impacted, can you?

Mr. GENSLER. I think you can, sir, with all respect, and also as it relates to the SEC, there is no parallel section to 722(d) on the SEC side. There would be no way frankly for us to do a joint interpretation when they don't have it in their statute and we do in the Commodities Exchange Act. So I think that we have coordinated very well with the SEC and gotten those joint rules behind us. On cross-border application, we are coordinating but, frankly, there is a different statutory framework to interpret.

Mr. HULTGREN. Well, I disagree. I think there is still significant amount of misunderstanding over those definitions. There is clear fear over it. It is paralyzing many entities.

Switching gears a little bit, I come from Illinois. I have large electric co-ops, also large electric companies there in Illinois, and there have been some very serious concerns on those entities of what the impact of the definition of *swap dealer* and *swaps* will be on that. Why did the Commission appropriately raise the proposed overall *de minimis* level from $100 million to $3 billion but didn't raise the level for special entities such as public power companies and other utilities?

Mr. GENSLER. Because we put it out to public comment. We received a lot of comments with regard to the overall level. We didn't get comments—there was one small comment—comments on special entities. Just to refresh, Dodd-Frank said that if somebody was dealing with a municipal or a pension fund, they had to have additional sales practice and treat them as—Congress called it—special entities. So we had a more narrow definition there. But we have worked very well with the rural electric cooperatives and the municipal power companies. They have a petition in front of us. We have that in front of our Commissioners to hopefully in the next few weeks or months put that out to public comment for an exemption for the municipal power companies dealing with what is called 201(f) rural electric cooperatives.

Mr. HULTGREN. Just a quick follow-up on that. My question really is, my understanding with Dodd-Frank was recognition of threats to market really in response to the financial crisis. I would just ask what role power companies had in creating the financial crisis.

Mr. GENSLER. We are working with the municipal power companies and the rural electric cooperatives to have an exemption for them, and we worked through that *swap* definition so that many, many electricity contracts that they had concerns with were addressed. I know the Edison Electric Institute put out some comments about what we had done. They continue to come in on very important but narrow issues, and we are going to continue to work with them on that, but I don't think that the municipals and the rural electric co-ops and so forth are going to become swap dealers and so forth.

The CHAIRMAN. The gentleman's time has expired.

Mr. HULTGREN. Thanks, Mr. Chairman.

The CHAIRMAN. The chair now recognizes the gentlelady from Ohio, Ms. Fudge, for 5 minutes.

Ms. FUDGE. Thank you very much, Mr. Chairman, and thank you, Chairman Gensler, for being here today.

I just really have two questions. The first one is, in your testimony, you assert the need for increased appropriations for CFTC in order to allow it to better serve the American people by providing sufficient oversight. In light of the need for greater oversight and of course recent events as well, do you believe that the private regulator NFA is really up to the task or do you believe that the American people would be better served by having one centralized Federal regulator?

Mr. GENSLER. Well, this is embedded in our oversight for decades, this system of front-line regulators and then the Federal regulator overseeing this front-line regulator. So we are taking a deep dive and looking very closely at how to enhance this system. Frankly, we don't have the resources. I mean, this is not just decades old for other reasons but we don't have those resources.

Ms. FUDGE. Right. If you had the resources, my point is, does it work the way it is? Do you have the confidence in the private regulator that you should have?

Mr. GENSLER. We are doing everything to enhance it. We have worked closely with the self-regulatory organizations that you will hear from in the next panel to enhance it. I think in this circumstances of Peregrine and as evidenced, it did not serve the benefit of these people. But the reality is, this has been here for decades. It is enshrined in statute.

Ms. FUDGE. That is not my question.

Mr. GENSLER. I know. I respect that the challenges of this self-regulatory organization or Federal regulators is going to be similar. My answer is, whether it is at a self-regulatory organization or at the Federal regulator, we need to make sure that we have windows directly into these accounts, that we have enough enforcement and a culture of enforcement between them and ourselves. I think it can work either way, by the way. I think it is can work either way but this is what has been enshrined for decades.

Ms. FUDGE. Well, since you don't want to give me a direct answer, we will go to the next question.

And this has been talked about, people have touched on it today, but I mean, certainly we understand that the public needs some real protection and some certainty. And people have asked you about timelines. Could you please discuss the timelines for completing the rulemaking under Dodd-Frank?

Mr. GENSLER. We have been at this about 2 years and we have just under 20 proposals that are out but haven't been finalized. I think the bulk of them, not all of them, will be finalized by December 31st. There are some we have chosen to wait like the international margining regime to line up with other regulators. The timeline beyond that is, we will still continue to phase compliance well into 2013 in terms of bringing people in because markets need time to adjust and to lower the burden and let this come into place.

Ms. FUDGE. Thank you very much, Mr. Chairman. I yield back.

The CHAIRMAN. The gentlelady yields back the balance of her time. The chair now recognizes the gentleman who represents most of the great State of Kansas, Mr. Huelskamp, for 5 minutes.

Mr. HUELSKAMP. Thank you, Mr. Chairman, and Chairman Gensler, thank you for joining us here today. I would like to direct some questions to the Peregrine incident. How many years was wrongdoing occurring there based on information you have?

Mr. GENSLER. I am sorry. This is Peregrine?

Mr. HUELSKAMP. Yes.

Mr. GENSLER. We are still trying to develop the facts. His note that he left when he attempted to take his life said that it had been for quite some time, maybe up to 20 years, but we do not have independently verifiable data to say that. In some cases, banks and others only have records for 7 years. So it may well be that we won't know the answer to that with certainty, but his note says maybe up to 20 years.

Mr. HUELSKAMP. And during those 20 years, how many times was that company audited or reviewed by your entity?

Mr. GENSLER. It would have been audited by outside folks every year and the NFA every 9 to 15 months. The CFTC, as I laid out in the written testimony, conducted a number of limited-scope reviews in the 1990s that led to an enforcement action in 2000 where Peregrine had to bring others in—PricewaterhouseCoopers. We also in 2007 and 2008 did some limited-scope reviews on matters that are outlined and then one more in 2010 on anti-money laundering. These limited-scope reviews are not audits in the full sense of the word but we look at papers and specific issues that have come to our attention.

Mr. HUELSKAMP. Did you ever call the bank to verify the account balances that apparently this CEO was falsifying and submitting for your reviews?

Mr. GENSLER. Though I am not aware of all the details in all of these reports over the years that CFTC might have done, the first-line auditors would have been the CPAs and the National Futures Association, but I am not aware of any calls to the bank, U.S. Bank or Harris Bank or the other banks, but it may have occurred.

Mr. HUELSKAMP. And you mentioned PricewaterhouseCoopers. Certainly they would have verified the account balances, would they have not? I mean, you directed them as part of a finding to find some outside help for this issue.

Mr. GENSLER. Under the rules of the CFTC, written enforceable rules, the yearly CPA has to use Generally Accepted Auditing Standards, and as I understand it, those auditing standards do require what you just said about the confirmations of assets, custodial arrangements in banks.

Mr. HUELSKAMP. So if it was 20 years, if the suicide note was apparently the basis for your charges and been occurring for 20 years, then this outside entity that in 2000 actually should have looked at those records as well?

Mr. GENSLER. Again, there are a lot of facts we are going to learn but I think that you are correct, sir, that outside auditors and even in the audit routines of the National Futures Association is to confirm key balances.

Mr. HUELSKAMP. On January 25th, Mr. Chairman, you have a press release still on your website, *CFTC Releases Results of Limited Reviews of Futures Commission Merchants.* That review did include this firm in question?

Mr. GENSLER. Yes, it was reviewed by the NFA as part of that limited-scope review.

Mr. HUELSKAMP. And what was the role of the Commission in the review?

Mr. GENSLER. We looked at the top, I want to say 10 or 12 largest futures commission merchants and then the Chicago Mercantile Exchange took the next group and then NFA took their direct regulated entities.

Mr. HUELSKAMP. So the CFTC didn't review the entity in question here, it was NFA?

Mr. GENSLER. No. The last time we did a limited-scope review was on anti-money laundering. It was maybe a year and a half ago at Peregrine.

Mr. HUELSKAMP. Obviously, Mr. Chairman, with the $1.6 billion lost through MF Global and the uncertainty out there, why would you put anything out to the public assuring them that—and this was assurance to the marketplace and that is how it was treated—if you hadn't done the work and again we are relying on outside groups to determine the effectiveness of your regulatory system?

Mr. GENSLER. Sir, I will even go further. This was an attempt to deceive the regulators and the public for what may have been many years. The deception would have continued all the way until July of this year throughout this period of late last year, and I believe that we need to do more and we need to do better, but this was an outright fraud, forged bank statements, forged—so even this would have occurred in November or December when the NFA took their limited review at that point.

Mr. HUELSKAMP. And I appreciate that. Thank you, Mr. Chairman. I find it troubling that we would put this type of assurance out, screwed up in MF Global, screwed up on this entity and then here we are telling the marketplace in January and then find out later at the various time this assurance was given that we had these problems still out there. I have constituents that lost funds in both entities through a massive failure, and so I appreciate the answers, Mr. Chairman. I look forward to your further research. I yield back.

The CHAIRMAN. The gentleman's time has expired. The chair now recognizes the gentleman from Connecticut, Mr. Courtney, for 5 minutes.

Mr. COURTNEY. Thank you, Mr. Chairman, and first of all, I just want to join my friend, Mr. Conaway, in complimenting the work that CFTC did in the Barclays case. Again, just for the record, the U.S. Treasury is collecting $160 million in fines from Barclays as a result of that enforcement action. Isn't that the——

Mr. GENSLER. It is actually $360 million, because it would be $200 million in our action and $160 million in the Department of Justice.

Mr. COURTNEY. Great. So again, just sort of going back to your point about resources and CFTC's total budget cost to the taxpayer, again, the President's submission this year was for a budget of about $300 million. Is that correct?

Mr. GENSLER. That is correct.

Mr. COURTNEY. Obviously we don't want you to be in the position of, to use another metaphor today, of a police officer writing speeding tickets to pay for his budget, but the fact of the matter is, is that having an adequately financed CFTC will in fact result in benefit to the taxpayer through enforcement actions that in some instances collect fines but also hopefully regulate behavior that is going to be a benefit to consumers and small businesses.

Mr. GENSLER. I think we are a good investment to the American public because markets will work better, end-users will get a better deal in these sophisticated markets, and you are right, occasionally there will be large enforcement fines but we have to knock on every door that the Chairman said we have to knock on.

Mr. COURTNEY. And to follow up on Mr. Huelskamp's questions, I mean, the fact is, is that the situation at Peregrine, in my opinion, really demonstrates the weaknesses that existed pre-Dodd-Frank in terms of your ability to detect outright cases of fraud and deception. One of the rules that you have just promulgated, which is in your testimony, is that you are actually beefing up CFTC's ability to crack down on actual cases of deception by having whistleblower authority, which obviously didn't exist years ago when the Peregrine situation was unfolding. We can never know whether or not that would have flushed it out, but the fact is, is that when there are these outright cases of deception, having these more robust authorities through Dodd-Frank is actually going to help detect actual cases of fraud and deceit. Isn't that correct?

Mr. GENSLER. I think that is correct. You have also enhanced the anti-manipulation rules. We now have gone to a recklessness standard from intent-based. It would be easier to pursue cases around benchmark interest rates like LIBOR, so you have enhanced a lot.

Mr. COURTNEY. And again, one of the other metaphors that you heard from my friend, Mr. Southerland, was that an ounce of prevention is worth a pound of cure. I mean, in fact, that is exactly what CFTC is doing by again sort of creating a new regulatory structure which you described in your opening comments so that we don't again end up in situations like 2008 or MF Global, *etc.* I mean, that is exactly what you are trying to accomplish, isn't it, with the regulations?

Mr. GENSLER. That is true, but I would say we are never going to repeal human nature. We bring about 100 enforcement cases a year. We have Ponzi cases and we will be having Ponzi cases for decades to come, unfortunately. This Peregrine situation while technically not a Ponzi case has all of the sort of *indicia* of a similar fraud where somebody has deceived their customer base and stolen.

Mr. COURTNEY. Right. And last, in terms of the Dodd-Frank position limits regulations which I usually ask you about every time you visit us, again, we are now sort of moving towards actually a launch date. Isn't that correct, in terms of the position limit rules going into effect?

Mr. GENSLER. That is correct. Two months after this joint definition of the word *swap* is in the *Federal Register,* swap-month positions limits will be effective for 28 commodities for swaps and futures, so sometime in October most likely.

Mr. COURTNEY. Well, I just want to say, Mr. Chairman, for the record, that there are a lot of small businesses, particularly people who are end-users in the energy sector, certainly in my state, who are looking forward to that date with great anticipation and happiness. Hopefully this measure which is moving forward in the House this week to freeze all regulations in its track, a chainsaw throughout the whole government, won't move forward because even though the stated purpose of that bill is to protect small businesses, the fact of the matter is, it is the end-users who rely on the futures market for energy who would be hurt by freezing that regulation from going into effect.

And with that, I would yield back, Mr. Chairman.

The CHAIRMAN. The gentleman yields back. The chair now recognizes the gentlelady from Ohio, Mrs. Schmidt, for 5 minutes.

Mrs. SCHMIDT. Thank you. Thank you very much.

Mr. Chairman, I believe your core mission is oversight and enforcement and yet since you have been Chairman, two of the largest failures in future brokers have occurred under your watch, and listening to your testimony today, I mean, you told the gentleman from Colorado that you should be held accountable. That was your words. You told the gentleman from Florida that now you are going to be looking at electronic transactions to make sure that what is said to be put in a bank should be put in a bank. And I am a little confused because it was under your watch that these systems failed and shouldn't you have been doing that all along? I believe the buck stops with you. We can continue to put out more regulations but if you are not being the watchdog, then the systems are going to continue to be hurt. So I am just asking you, how did this occur under your watch?

Mr. GENSLER. The CFTC is very vigilant, but as you may be aware, the front-line regulation, the front-line examination function of intermediaries in these markets is with the National Futures Association or the Chicago Mercantile Exchange or other self-regulatory organizations. That is enshrined in statute. So we oversee the self-regulatory organizations. We have done a great deal to enhance the investment of customer funds and protections around that, sometimes even criticized that we were doing things that weren't in Dodd-Frank like saying we can no longer have what was called in-house repurchase agreements, taking customer money and lending it to others.

But this situation here shows that we need to change the rules of how firms are audited and the direct electronic access to these accounts. This was deception, this was fraud, and that will occur from time to time, but I am agreeing with you that we need to do all we can do to protect the customers.

Mrs. SCHMIDT. But you are relying on outside firms, the NFA, your last limited-scope review, you used their findings, and yet you look at certain things in the past that have occurred that should have put up red flags. If you are the watchdog, then maybe you should do your own internal investigation a little more diligently. I am looking at a lot of people who have lost money and this isn't the first time that we have had this discussion in this room, and all I hear is, we need more regulation, more rules, more authority. I am not seeing you or your organization doing its core mission right now, which is oversight and enforcement, and I am not sure any more rules are going to allow you to do the job better.

So I am asking you, doesn't the buck stop with you and where is your leadership in this? I mean, are you spending so much time in rules and regulations that you don't have time to look at these audits and see if they are true and effective at what they are stating?

Mr. GENSLER. With all respect, we brought more enforcement actions last year than any time in the history of this agency: 99. We have stepped up our enforcement of segregated accounts where for 7 years there hadn't been a case and then under the last 3 years——

Mrs. SCHMIDT. But you had two of the largest failures in futures brokers under your watch.

Mr. GENSLER. I understand.

Mrs. SCHMIDT. So regardless of everything else that you did, the big boys you didn't look at.

Mr. GENSLER. And we have restructured and hired new leadership in our examination and our intermediary oversight functions but yes, we need to do more. This Peregrine situation was direct deception. We have done a great deal, but I am agreeing with you——

Mrs. SCHMIDT. But you did limited-scope reviews. Shouldn't you have done a little bit more? I mean, they had a red flag a few years ago. Shouldn't you have continually watched them to make sure that they were being good players in this and not just using a little checkmark and moving on?

Mr. GENSLER. With all due respect, with the funding we have, we are so limited in resources. I have been in front of this Committee over and over again so I am just going to say, we relied for decades on self-regulatory organizations as a front——

Mrs. SCHMIDT. You relied on somebody else instead of your—I am sorry. I yield back.

The CHAIRMAN. The gentlelady yields back the balance of her time. The chair now recognizes the gentleman from California, Mr. Costa, for 5 minutes.

Mr. COSTA. Thank you very much, Mr. Chairman.

I think the conversation that we have had here today really revolves around a transition that is taking place post-Dodd-Frank. I am one of those that believes that as we are going through this transition, formulation of the rulemaking, the timelines that you started to explain in some of the questioning that progress has been made. You have been asked the question in a number of different ways. I think you just stated it in response to the last question. But do you really believe you have enough resources at this point in time to perform the role of risk assessment and risk management and enforcement that is necessary as the Commission?

Mr. GENSLER. No, we don't have enough to oversee the futures market that has grown five-fold since the 1990s and we are only ten percent larger than 20 years ago, and we don't have enough to ensure that we can oversee the swaps marketplace that is eight times larger.

Mr. COSTA. What would you anticipate you would need in terms of resources to address the question that was just asked by the Congresswoman to provide the level of scrutiny and enforcement necessary to avoid these kinds of frauds?

Mr. GENSLER. With all due respect to the question, though the President's budget is $308 million, which is about $100 million than we are currently funded at, Congress in statute in 2000 said we were to rely on self-regulatory organizations. If we were to be the front-line regulator to actually do the audits, that is not in the President's budget and it is not what I am recommending here today. I mean, we have a self-regulatory system. What we need to do is ensure that the CFTC examines those self-regulatory functions better, that we do what we do and what Congress has directed us to do better in examining them and making sure that the system works for the American public.

Mr. COSTA. Do you anticipate being able to coordinate resources with clearinghouses? You are talking about the timelines in Japan, the timelines in Hong Kong, and the timelines for implementation in Europe with those other clearinghouses to try to provide a worldwide regulatory framework.

Mr. GENSLER. I think we are coordinating well but we have different politics and different cultures so there will be different timelines. In some countries, they might be significantly later than us but I am encouraged by Europe and Japan and Canada.

Mr. COSTA. For your discussion of those timelines, could you provide the Committee, because you talked about you are almost at the rulemaking now, what you see the timelines out for the next 2 years? Would that be possible?

Mr. GENSLER. I am sorry. Did you say for the next——

Mr. COSTA. Two years.

Mr. GENSLER. Two years? I think we can provide something to you in terms of the rules that are already finalized when there are compliance dates and then second, when we——

Mr. COSTA. Mr. Chairman, I would like that provided to the Committee so that we can all have a better understanding of that.

[The information referred to is located on p. 105.]

Mr. COSTA. I want to understand the context that you made this statement. I thought I heard you say earlier in response to questioning that you would support letting the banks fail. I suspect we are talking about including those banks that are too large to fail?

Mr. GENSLER. I think a corner grocery store in America can fail, a farmer can fail. I mean, it is about risk and innovation.

Mr. COSTA. But you don't believe there is such concept of too large to fail?

Mr. GENSLER. I think that we are better if there is a freedom to fail in our economy, and then——

Mr. COSTA. So what is your definition of *moral hazard?*

Mr. GENSLER. If the markets believe that an institution will be backed by its government and that it is able to borrow at lower rates, it distorts markets.

Mr. COSTA. I have a local question, because my time is running out here. Do you recall the discussion we had earlier this year on several investor-owned utilities in California and California's regulatory environment, concerns that I expressed and some of my colleagues that the state's energy providers could inadvertently be swept up in the *swap-dealer* definition? We understand that you and the Commissioners have been working on this, with the stakeholders to provide a clarity needed to ensure that they and ultimately California ratepayers are not penalized. Can you give me a quick update on where you are on that?

Mr. GENSLER. I think we did well in the *swap* and *swap-dealer* definition. It may have also been some issues about the environmental-rights contracts that we specifically addressed in the *swap* definition. The last important piece of business is that we have in front of us a petition from last month from the municipal electric co-ops and the rural electric co-ops for an exemption, and that document is in front of Commissioners and I am hoping that we will put it out for a short comment period in the next month or so.

Mr. COSTA. If I might, Mr. Chairman, my time has run out, but pertinent to this question, there is a timeline issue, the next 60 days, I understand, to comply with the documentation on that. Is there any flexibility in that 60 day timeline period?

Mr. GENSLER. I am sorry. For——

Mr. COSTA. To comply with information requests from real swap dealers and major participants while they are trying to implement their own compliance with the changes that you have made for these public- and investment-owned utilities.

Mr. GENSLER. Maybe we can follow up afterwards because I am not sure I—the question about the municipal co-op and so forth, we are going to be putting out hopefully very shortly to get public comment. They are not swap dealers, from what I understand, so I don't think they are going to——

Mr. COSTA. No. Well, I don't believe they are either, but as I understand it, in response to the earlier efforts that the Commission provided to work out this distinction because we don't believe they are swap dealers. But you have to comply in the case of California with the state's regulatory regime that they come in compliance, but they expressed to us that they had a concern about the timeline that you had provided for them.

Mr. GENSLER. I look forward to following up with your office to better understand that.

Mr. COSTA. Okay. Thank you, Mr. Chairman.

The CHAIRMAN. The gentleman's time has expired. The chair now turns to the gentleman from Pennsylvania, Mr. Thompson, for 5 minutes.

Mr. THOMPSON. Thank you, Chairman.

Chairman, thanks for being here and addressing these important issues. I have just two questions for you, pretty diverse questions, though, but both relate to the Dodd-Frank rulemaking but goes from impact on individual farmers and then also our market's access to other markets.

So let me start with the local one first with farmers. You know, obviously many in rural America are concerned with the CFTC's requirement that telephone conversations with farmers about forward cash contracts need to be recorded and the records kept for 5 years. It seems like regulatory overkill really, at its finest. Can you give us any assistance—any assurance—I am sorry—that this is not the Commission's intention?

Mr. GENSLER. It is not, but this was included in a conforming rule where members of contract markets needed to record their conversation, and we have gotten a lot of comments and we are looking at how to dial that back in any final rule so that it is really just about that member and what they are doing directly on the exchange and so forth.

Mr. THOMPSON. Well, I appreciate you looking at that and I appreciate your desire to stay with the original intention and dialing back on that.

And then the opposite end, more about world market access. Mr. Chairman, you have repeatedly assured the Committee that CFTC has fully coordinated with international regulators but then we read letters from foreign regulators threatening to ban their country's firm from our marketing, and I have a copy of a letter from a Swiss regulator, the Swiss Financial Market Supervisor Authority, FINMA, and also in addition an op-ed in the *Financial Times* written by your European counterpart that seems to indicate that anything but coordination is happening. If the CFTC was really coordinating with international regulators, one would assume that they would not have to resort to writing opinion editorials in the newspaper to get your attention.

Now, because our financial reform was so far ahead of the rest of the world, how can we at this point, how can you assure this Committee that the markets of the United States are not going to suffer due to the lack of international coordination, especially since it appears most of the rest of the world is playing catch-up.

Mr. GENSLER. They have made very good progress. I had a very good conversation with the author of the letter from Switzerland yesterday, and Michel Barnier, who wrote the opinion piece, and I have had a very good relationship and continue to even though he expressed his views in an opinion piece, as you say. What we are trying to ensure on the cross-border side is that risks booked offshore don't come crashing back to our taxpayers here. That is really what—and that is the interpretation of *direct and significant.*

With regard to the Swiss situation, they have a situation and France has something similar about secrecy laws. You are probably familiar with Switzerland and the banking system and so they have a set of issues as to how their banks can provide risk transactions to somebody in your home state or in any state in America and report that information to a data repository. That is kind of the core issue that he and I were talking about yesterday about their secrecy laws. It is not an easy issue but it has to do with a number of countries, particularly Switzerland and France.

Mr. THOMPSON. Thank you, Chairman.

Mr. Chairman, I yield back.

The CHAIRMAN. The gentleman yields back the balance of his time. The chair with great enthusiasm now recognizes the gentleman from Georgia.

Mr. DAVID SCOTT of Georgia. Thank you, Mr. Chairman.

Mr. Chairman, let me ask you this. I certainly appreciate your stated desire to increase capital efficiency through portfolio margining, particularly in the credit default swaps market, and certainly appreciate your work with Chairman Schapiro and the SEC on an agreement in this area. It is my understanding that some progress has been made but there are some significant issues that remain. I am particularly concerned that the lack of a regulatory solution will likely prevent clearing among credit default swap customers and that would occur if portfolio margining benefits were offered.

Now, your agency and the other agency staff has worked on this for well over a year now. So Mr. Chairman, enough time certainly has been spent to understand this issue, and what I suspect is needed in this case for you and the other Commissioners including Chairwoman Schapiro of the SEC is to send a message that this issue needs to be resolved so that broad-based clearing of credit default swaps will go forward as Congress intended so that the taxpayers will be protected. Now, can I get your commitment that you will provide this leadership, Mr. Chairman?

Mr. GENSLER. I support portfolio margining between securities-based swaps, which are called single-name credit default swaps, and broad-based credit default swap indices, and there has been a petition in front of us with regard to that. I am supportive. It has a challenge at the Securities and Exchange Commission. It takes two sets of agencies to come together. We have made great progress on other things, joint rules, defining swaps and other things. This one, as you have rightly noted, is not over the line yet but I am supportive of portfolio margining.

Mr. DAVID SCOTT of Georgia. So you have been at it for a year now. I mean, the problem is that patience is wearing thin. How much longer do we have to wait and why can't we—what is the problem here? What is the holdup?

Mr. GENSLER. The Securities and Exchange Commission approach to this is different than the petitioner. The petitioner is IntercontinentalExchange in front of our two Commissions. They have a different approach to it, so it has to be worked through between the SEC and the ICE on these matters to see how to close that gap.

Mr. DAVID SCOTT of Georgia. Can you give us an estimate of about how much longer this would take?

Mr. GENSLER. I don't know because I am sorry to say that when it comes to portfolio margining and the markets, the margining regimes for futures and securities are quite different, and we could be very supportive at the CFTC but it needs both agencies.

Mr. DAVID SCOTT of Georgia. Let me ask you something else. I am struggling to understand why we continue to support this SRO model of regulation when we seem to have one large-scale process failure after another, whether it is Madoff or Stanford or MF Global or recently PFGBest, but my constituents, I tell you, back in Georgia are screaming for change. Our farmers are screaming for change. The people of America are sick and tired of seeing their livelihoods put at risk by greedy malefactors who are enabled by a system that seems to be little more than a good old boy network. We have seen it time and time again. What on Earth do you all say to them? What do you say to America when it is situation after situation after situation?

Mr. GENSLER. Well, I say the system in 2008 revealed it as well. The financial system needs common-sense rules of the road and we need to do more on customer protection. We have done a lot. We have restructured. We have put in place new rules. We have brought significantly more enforcement actions but even this case at Peregrine highlights that we have to take a very close look at the self-regulatory organizations and the CFTC, be self-reflective and where we have to change, change appropriately.

Mr. DAVID SCOTT of Georgia. Well, is there any value left in this self-regulatory organization model?

Mr. GENSLER. Well, we have had it for decades and it served the nation in many tough market environments, so what we are focused on is how to improve it, not to uproot the whole thing but to change it and enhance it.

Mr. DAVID SCOTT of Georgia. Thank you, Mr. Chairman. I yield back.

The CHAIRMAN. The gentleman's time has expired.

The chair now recognizes the gentleman from Iowa, Mr. King, for 5 minutes.

Mr. KING. Thank you, Mr. Chairman.

I thank you, Chairman Gensler, for your testimony today. I spend part of my time over in the Judiciary Committee where we get some of the Cabinet Members testifying, and they don't come forward with the intent to try to inform the Committee as openly as you do. I know we have disagreements but I do believe your testimony has been directed at informing us with the best answers you can deliver in a truthful fashion.

So I have a couple of things I would like to ask you to clarify, and that is, I was only half listening when one of the other Members of the Committee made a comment, and I just heard your response that this was an outright fraud, and I wasn't clear whether that was Peregrine or MF Global or Corzine or Barclays, whom that might be. Could you clarify that for me, please?

Mr. GENSLER. I thank you for the compliment. I think I was referencing Peregrine, but I would say on the LIBOR situation and Barclays, they have settled and that was false reporting under our Act, which some people would use the broader circumstance in question. It is not right to lie about such an important rate.

Mr. KING. So I will write f*alse reporting and lying.* Is that not also the definition of *fraud?*

Mr. GENSLER. Because I am not a lawyer, I am just going to be careful, but what we actually settled on is attempted manipulation and false reporting, but for your constituents and for my mom, I think they would see it about the same way as lying.

Mr. KING. I do agree with that, and again, as I listened to your testimony, when you said we need to change the way these firms are audited and have direct electronic access to these accounts, hasn't history pretty much shown us that regulation once it is established, the people that are intending to circumvent it, whether it is deception, lying or outright fraud, have found a way around regulation throughout history?

Mr. GENSLER. I think human nature shows that, so we have to stay abreast of it, and when we enhance this in the next few months, there might be another fraudster in 2014 or 2017 that will find another way to test the system.

Mr. KING. I would think sometimes about the history of warfare. When someone invents an offensive weapon, someone else invents a defensive weapon. The sword and the shield or the arrow and the shield would be an example, and now we have Star Wars to defend us from missiles from other continents. So I think that is an appropriate metaphor for what is going on here is that we are trying to regulate and build shields against the people that are engaging in or intending to engage in fraud in our financial markets, and I would like to say that is what these regulations are about.

But I would like to turn this a little bit and take this to an understanding that we haven't been able to write regulations that are successful, at least always successful, and the creative people that are out there will find another way around it. The free markets have done a pretty good job of protecting the interest if they get a chance to see what those assets actually are, and so would it be your opinion that the restraint of markets without the promise of government bailout is an effective shield?

Mr. GENSLER. Well, I absolutely agree with the second part. There should not be government bailouts. I do think that commonsense rules of the road to bring transparency to markets help our economic well-being, and I think that has helped in the securities and futures markets, and that is what Congress said to bring to these swaps markets.

Mr. KING. Do you, though, get the sense that traders in the marketplace, especially these traders that happen to be members of the—I can see five farmers co-ops in my neighborhood that suffered a loss of $47.5 million altogether to MF Global. They get a sense that because government is regulating, that they are protected in their investments. How much of a factor do you think that is in the confidence in the marketplace that the government is the regulator and the protector?

Mr. GENSLER. Well, I think that farmers need to have confidence to use these markets so they can lower their risk. I mean, what is the price of corn going to be at harvest time and they can use a futures contract to lower that risk, lock in it. So that type of confidence is a good type of confidence. Is there is an effective cop on the beat? But I agree with you not to have the confidence that we are going to bail out banks or ensure against poor corporate behavior.

Mr. KING. So what we are really after here then is balanced restraint that investors have to control their speculation judging upon two things, and that is, how solid are the financials of the entity they are dealing with and how effective is the financial regulation that comes from the government. That would be the two pieces of this that would have to be kind of married together?

Mr. GENSLER. Right, so that investors have the facts and figures to make their investment choices, that they have markets that function well, that they can hedge these risk in these derivative contracts, and of course, that we don't stand behind——

Mr. KING. And you would like to have direct electronic access to the accounts but you wouldn't propose that to the investors to have that same access?

Mr. GENSLER. I actually think investors should know in these markets where their money is held, so just like they do in a mutual-fund statement, I actually do think that they should know where their money is.

Mr. KING. Thank you very much, Chairman, I appreciate your testimony, and I will submit some questions for the record.

The CHAIRMAN. The gentleman's time has expired. The chair now recognizes the gentlelady from South Dakota, Mrs. Noem, for 5 minutes.

Mrs. NOEM. Thank you, Mr. Chairman, and I appreciate this hearing. It is timely given it is the second anniversary of the Dodd-Frank and we need to look at these reforms and the related rules and see how they impact people on the ground. For example, in South Dakota, where I am from, some businesses and producers who are actively investing in the commodity market are still dealing with the failure of MF Global, so I just have a couple questions for you.

Does the CFTC have the power to force a firm into bankruptcy?

Mr. GENSLER. We might need to get back to you, but I am not aware of that. Even in this Peregrine situation, we went into court to ask for a receiver to be appointed to freeze the assets, which we do in Ponzi schemes as well. So I think that is the route. I believe the answer is no but we seek a court to appoint a receiver.

Mrs. NOEM. Okay. That is the route that is generally followed? Well, if there is more information on that that you can give me later, I would appreciate that. That would be great.

[The information referred to is located on p. 106.]

Mrs. NOEM. What role does the CFTC play in initiating the bankruptcy of such as like MF Global?

Mr. GENSLER. A broker dealer—I am not involved in that specific thing but a broker dealer goes into this proceeding under the Securities and Investor Protection Act, and that is under the securities law, so we don't have a direct role. But then we do have a role in appearing in front of the court and appearing in front of the trustee to ensure that the commodities exchange laws are followed, that the segregated funds are for the customers.

Mrs. NOEM. So is that more of an informational-type role that you fulfill with the courts. Are you summoned in a manner?

Mr. GENSLER. Well, it is both an informational role and also to advocate and file motions on behalf of those segregated accounts, as I understand it.

Mrs. NOEM. Excellent. Thank you. I appreciate that.

With that, Mr. Chairman, I will yield back.

The CHAIRMAN. The gentlelady yields back the balance of her time. The chair now recognizes the gentleman from Indiana, Mr. Stutzman.

Mr. STUTZMAN. Thank you, Mr. Chairman.

Thank you, Chairman Gensler, for being here. I would kind of like to follow up on the gentlelady's questions regarding MF Global.

At what point did you alert your fellow Commissioners of your recusal from the MF Global investigation?

Mr. GENSLER. I informed the General Counsel on a Thursday, so it may have been that Friday. We have a weekly surveillance meeting on Friday. That goes back decades. And so the firm went into bankruptcy on a Monday. The first surveillance meeting was going to be that Friday, so I did not attend that surveillance meeting and informed various Commissioners. One, Commissioner Sommers, was on vacation but the other Commissioners——

Mr. STUTZMAN. So you did notify them?

Mr. GENSLER. I believe it was that Friday.

Mr. STUTZMAN. How did you notify them? By electronic——

Mr. GENSLER. If I remember, I had personal conversations with three of them and then General Counsel Berkovitz reached out to Commissioner Sommers, who was in Florida with her family.

Mr. STUTZMAN. Okay. So your recusal, is that consistent with CFTC's process in recusals?

Mr. GENSLER. Well, the General Counsel and the ethics officers actually advised me that I did not under the laws need to step aside. I thought it was best not to participate. Jon Corzine, who had been the Chief Executive Officer there, had been way back when I was at Goldman Sachs a partner of mine and ultimately my boss at Goldman Sachs. So, I handed this off to the dedicated enforcement staff and other enforcement officers and the Commission, and not participate in this matter as it turns on an enforcement matter that might involve, personally, Jon Corzine.

Mr. STUTZMAN. So help me understand, when did you first hear there was a loss in customer segregated accounts?

Mr. GENSLER. About 2:30 a.m. Monday morning.

Mr. STUTZMAN. And then did you have any conversations with Mr. Corzine during the final week of October?

Mr. GENSLER. No, no personal conversations, no business conversations. There was a group conference call that Sunday when the CFTC, the SEC and regulators from London and the New York Federal Reserve were on a big conference call with the company and its advisors about moving the customers' funds. At that point Sunday, it was about moving the customer funds to some fund called Interactive Brokers, and I believe Mr. Corzine spoke up in that call that might have had 20 or 40 people on it.

Mr. STUTZMAN. That was on Sunday?

Mr. GENSLER. Sunday, October 30th.

Mr. STUTZMAN. And so you were notified at 2:30 a.m. Monday morning?

Mr. GENSLER. Yes, Monday morning. I was woken up.

Mr. STUTZMAN. So during those conversations, or during that conversation, was there any discussion of the customer accounts and segregation of funds brought up?

Mr. GENSLER. In the regulators call, what we were focused on was moving those customer accounts to Interactive Brokers. We had laid out by that Sunday evening a number of conditions about that. Interactive Brokers agreed to those conditions and MF Global as well that they would be fully guaranteed and all the monies and positions would be moved to Interactive. Of course, then at 2:30 I was woken up.

Mr. STUTZMAN. September 1, 2011, MF Global announces in a public filing that it would comply with FINRA's determination and increase its capital. Would such a filing trigger any red flags at CFTC?

Mr. GENSLER. As I am not participating, I don't know what the Commissioners or the agency looked at about that September 1st filing. But just as a general matter, our examination staff will work with the self-regulatory organizations like FINRA and Chicago Mercantile Exchange and NFA on any filings about capital and try to understand what those filings are.

Mr. STUTZMAN. So did that happen? Did your agency work with FINRA at all?

Mr. GENSLER. Again, I don't know because I haven't gone back and done the forensics. I haven't been involved since this whatever, November 2nd or 3rd period of time.

Mr. STUTZMAN. Is that something you could find out and notify——

Mr. GENSLER. Our General Counsel, Dan Berkovitz, will follow up with you.

[The information referred to is located on p. 107.]

Mr. STUTZMAN. Thank you, Mr. Chairman. I will yield back.

The CHAIRMAN. The gentleman yields back. The chair recognizes the gentleman from Iowa for a follow-up question.

Mr. BOSWELL. Well, thank you. I am the temporary Ranking Member, I guess.

Mr. Chairman, earlier on in questions, I didn't give you a chance to answer because I got into a dialogue with Chairman Lucas, and I agree with his points. At the same time, we have responsibility that even though we are not appropriators, we have the tools or the doorknockers or whatever you want to call it. The idea that I threw out about the funding, would you have any comment you would want to make about that? I think you told Mr. Costa earlier that you did not have the resources, and so just expand on that and then we will be finished.

Mr. GENSLER. We don't have enough resources to cover the futures industry that has grown so significantly from the 1990s, or this new market that I would say is far more complex, this swaps marketplace that is eight times the size of the futures marketplace in notional value. It has at least twice as many actors on that stage.

We would work with Congress in any way Congress would wish to get funding whether it is direct appropriations, whether it is also working on fees or transaction fees similar to what the——

Mr. BOSWELL. The point of it is that this constant evaluation of the appropriations or coming from the Administration or whatever but if you had this fee system, it would kind of go with the ebb and flow of your need. It seems to be working for SEC. It seems to be working for NFA. That is one of the points. I want to know what you think about it.

Mr. GENSLER. I think that in the securities field, there has been a modest transaction fee to cover the cost to the SEC on an annual basis. I think President Obama has included that in his budget submissions. I believe previous Presidents, President Bush also did as well. So we would work with Congress. If you and the appropriators thought that was appropriate, we would be right at it with you, but if there are other ways to get the funding, I am kind of neutral on the way to do it but I am positive that we need more funding.

Mr. BOSWELL. But you clearly don't have the resources you need?

Mr. GENSLER. That is correct, sir.

Mr. BOSWELL. Okay. I yield back. Thank you, Mr. Chairman.

Mr. CONAWAY [presiding.] I thank the gentleman for yielding.

Chairman, one real quick follow-up. Section 722(d) is the section you cite that gives you the authority to do the guidance on the extraterritorial or cross-border; 722(c), we think gives the SEC similar authority. What is y'all's understanding or can you help us understand your interpretation of those two different sections?

Mr. GENSLER. Section 722(c) would be in the swaps section of the statute. It may well that you want to follow up with——

Mr. CONAWAY. Okay, if you wouldn't mind getting back with us on that because——

Mr. GENSLER. Because I understood that it is all in the first part of that Title VII is swaps, which is the CFTC, and then of course the other section later in the chapter is there but 722(c), Dan? Maybe we will have to——

Mr. CONAWAY. All right. We will follow up with you on that if you wouldn't mind.

[The information referred to is located on p. 108.]

Mr. GENSLER. No, I appreciate that, and thank you.

Mr. CONAWAY. Mr. Chairman, thank you for being here today. I appreciate your straightforward answers and look forward to visiting with you again soon.

Mr. GENSLER. Thank you very much.

Mr. CONAWAY. All right. If we can have the other panel step forward, we will get this one moving.

All right. While everybody is settling in, I will go ahead and introduce the witnesses. We have with us today Mr. Terry Duffy, Executive Chairman and President of CME Group, Chicago, Illinois; Mr. Dan Roth, President and Chief Executive Officer of the National Futures Association, Chicago; the Hon. Walt Lukken, President and CEO of Futures Industry Association here in D.C.; John Heck, Senior VP with The Scoular Company, Omaha, Nebraska, on behalf of the National Grain and Feed Association; and the Hon. Chuck Connor, President and Chief Executive Officer of the National Council of Farmer Cooperatives, Washington, D.C., and Mr. Paul McElroy, CFO of the JEA, Jacksonville, Florida, on behalf of the American Public Power Association.

Mr. Duffy, begin when you are ready, sir.

STATEMENT OF HON. TERRENCE A. DUFFY, EXECUTIVE CHAIRMAN AND PRESIDENT, CME GROUP, INC., CHICAGO, IL

Mr. DUFFY. Thank you, Mr. Chairman and Mr. Boswell.

We at the CME Group are appalled by PFG's theft of customer segregated funds. This fraud following MF Global has shaken the very core of our industry. Any breach of trust related to customer funds is absolutely unacceptable, whether at PFG, MFG or any other firm.

Since the failure of MF Global, CME Group and others in our industry have committed to strengthening the protections that guard customer property. The industry has recently implemented new regulatory measures, one of which was a new electronic confirm tool that uncovered Mr. Wasendorf's misreporting, forgery and theft, but more needs to be done.

CME and the National Futures Association have adopted four measures to deter, detect and prevent misuse of customer funds. Three have been implemented. The fourth will be made effective in coordination with the NFA next month. We have been conducting surprise reviews of customer segregated accounts since last December. We have implemented mandatory daily reporting of segregated statements by all FCMs and now we require bimonthly reporting to ensure that segregated funds are properly invested and held at approved depositories. Also in mid-July, CME began using *Confirmation.com*, an electronic method of receiving statements directly from third-party depositories to verify investment reports. We also began using *Confirmation.com* as a tool in our regulatory audits and plan to require banks to confirm segregated funds using this tool.

In direct response to the MF Global disaster, we will be implementing the Corzine rule on September 1st. The new rule requires that FCMs' CEO or CFO sign off on any withdrawals of customer segregated funds that exceeds 25 percent of excess segregated funds. Then they must also inform CME at the same time.

As I have said, more can be done. At the same time, CME believes that regulators and industry must be careful in weighing the costs and benefits of all proposals that may enhance protection for the segregated funds of our clients.

Some have suggested the creation of an industry-funded insurance program covering fraud and failure losses, possibly supplemented by privately-arranged insurance. Such a fund would certainly boost confidence but needs to be balanced against known negatives. The negatives are the obvious: it being cost-prohibitive and ineffective due to the amount of funds held in U.S. segregation. We need to develop procedures and systems that give regulators direct real-time access to customer segregated account balances, and we are working with regulators to do so. And while it may be controversial and perhaps have disruptive consequences, we should explore whether customer property not required as collateral at clearinghouses should nonetheless be held by clearinghouses or other custodians and whether safeguards should be into place to limit the ability of FCMs to transfer such property except to authorized recipients.

In addition, CME Group proposes that Congress amend the Bankruptcy Code to permit clearinghouses that hold sufficient collateral to support customer positions of a failed clearing member to transfer those positions of all non-defaulting customers with the supporting collateral to another stable clearing member.

While we expect that the misconduct of MF Global and PFG will renew calls for the elimination of the role of exchanges and clearinghouses in auditing and enforcement of their members, we do not believe that a legitimate case can be made to transfer these responsibilities to a government agency. CME Group is committed to working with the Congress, CFTC, NFA, FIA, and the market participants to reevaluate the current system to find solutions to further protect customer funds at the FCM level. We are also committed to restoring confidence in the markets that so many rely on for their risk management needs.

I thank you for the opportunity to testify before the Committee and I look forward to answering your questions.

[The prepared statement of Mr. Duffy follows:]

PREPARED STATEMENT OF HON. TERRENCE A. DUFFY, EXECUTIVE CHAIRMAN AND PRESIDENT, CME GROUP, INC., CHICAGO, IL

Chairman Lucas, Ranking Member Peterson, Members of the Committee, thank you for the opportunity to testify regarding the industry's efforts to deter, detect and prevent the misuse of customer funds. We, at CME Group, are appalled by the theft by Mr. Wasendorf of Peregrine Financial Group ("PFG") of customer segregated funds. This fraud, following MF Global Inc. ("MFG"), has shaken the very core of our industry.

Any breach of trust relating to customer funds is absolutely unacceptable, period—whether at PFG or MFG, or any firm. Since the failure of MFG, CME Group and others in our industry have been committed to strengthening the protections that guard customer property. The industry has recently implemented new regulatory measures, one of which was the new electronic confirm tool that uncovered Mr. Wasendorf's misreporting, forgery and theft. But more needs to be done.

In addition to the pressing issues raised by these recent deplorable actions, the Committee is examining at this hearing issues relating to the ongoing regulatory implementation of Dodd-Frank which I will also address at the end of my written testimony. Our concerns regarding the implementation of the statute center on ensuring that the rules do not needlessly hamper the strength, competitiveness and efficiency of the U.S. derivatives markets.

Industry Proposals to Protect Customers in the wake of MFG's Failure

On March 12th, a special committee composed of representatives from the futures industry's regulatory organizations, including CME (the "SRO Committee"), offered four recommendations to strengthen current safeguards for customer segregated funds held at the firm level. The first three have been implemented, and the fourth will be made effective in coordination with the National Futures Association ("NFA") in September:

- Requiring all Futures Commission Merchants (FCM) to file daily segregation reports.
- Requiring all FCMs to file bi-monthly Segregation Investment Detail Reports **("SIDR"),** reflecting how customer segregated funds are invested and where those funds are held.[1]
- Performing more frequent periodic spot checks to monitor FCM compliance with segregation requirements since last December.
- In direct response to the MFG collapse, the "Corzine Rule" will be implemented on September 1st. The "Corzine Rule" requires the CEO or CFO of the FCM to pre-approve in writing any disbursement of customer segregated funds not made for the benefit of customers and that exceeds 25% of the firm's excess segregated funds. The CME (or other SROs) must be immediately notified of the pre-approval.

In addition, to enhance intra-regulator coordination, we have established routine communications with FINRA for all of our common firms—the firm coordinators/relationship managers will reach out to each other to have these communications.

The SRO Committee has also implemented, or is in the process of implementing, the following initiatives:

- Using *Confirmation.com*—an electronic method of receiving account statements or balances from a third party bank or depository to check information provided

[1] Daily segregation reporting and bimonthly SIDRs were also recommended by the Futures Industry Association in its proposed initial recommendations made on February 29th. *http://www.futuresindustry.org/downloads/Initial_Recommendations_for_Customer_Funds_Protection.pdf.*

by FCMs to regulators. NFA's use of *Confirmation.com* uncovered the initial statement and reporting irregularities at PFG.

The SRO Committee plans to use the *Confirmation.com* tool as follows:

- ○ In regulatory audits now and going forward;
- ○ To verify bi-monthly SIDRs (investment reports). CME started using the tool for this purposed in mid-July; and
- ○ To periodically review the accuracy of daily segregation statements.

- Also, the SRO Committee agreed to develop rules to require all FCMs to provide them with direct online access to their bank or depository accounts to confirm segregated funds balances.

The Futures Industry Association's internal controls recommendations will be presented to the FCM Advisory Committee in August. These include:

- Requiring FCMs to assure the appropriate separation of duties among individuals working at FCMs who are responsible for compliance with the rules protecting customer funds;
- Requiring FCMs to document their policies and procedures in several critical areas, including the valuation of securities held in segregated accounts, the selection of banks, custodians and other depositories for customer funds, and the maintenance and withdrawal of "residual interest," which consists of the excess funds deposited by firms in the customer segregated accounts.

NFA's Website Access to FCM capital ratios and investment reports (SIDRs) will be presented to the NFA's Board of Directors in August.

CME Group Initiatives

Notwithstanding the fact that MFG's misconduct was the cause of the shortfall in customer segregated funds, CME Group's efforts in the wake of these events speak to the level of our commitment to ensuring our customers' confidence in our markets:

- *Guarantee for SIPC Trustee.* We made an unprecedented guarantee of $550 million to the SIPC Trustee in order to accelerate the distribution of funds to customers.
- *CME Trust Pledge.* CME Trust pledged virtually all of its capital—$50 million—to cover CME Group customer losses due to MFG's misuse of customer funds.
- *CME Group Family Farmer and Rancher Protection Fund.* On April 2, 2012, CME Group launched the CME Group Family Farmer and Rancher Protection Fund to protect family farmers, family ranchers and their cooperatives against losses of up to $25,000 per participant in the event of shortfalls in segregated funds. Farming and ranching cooperatives also will be eligible for up to $100,000 per cooperative.

  The Protection Fund is available to PFG customers that qualify under Program terms.
- *Agreement with MFG Trustee.* On June 14, 2012, the agreement between the SIPC Trustee for MFG and CME Group was filed in the Bankruptcy Court. It provides for the distribution of approximately $130 million of MFG proprietary assets, on which CME and its members held perfected security interests, to MFG customers. The agreement is currently under review by the Bankruptcy Court.
- *Bankruptcy Code.* The shortfall in customer segregated funds occurred only in regard to funds under MFG's control. The customers' funds held in segregation at the clearing level at CME and other U.S. clearinghouses were intact. However, the clearinghouses were not able to avoid market disruptions by immediately transferring those customer positions and any related collateral because of limitations under the Bankruptcy Code. We propose that Congress amend the Bankruptcy Code to permit clearinghouses that hold sufficient collateral to support customer positions of a failed clearing member promptly to transfer all customer positions with supporting collateral, except defaulting customer positions, to another stable clearing member.

More Can Be Done

However, CME Group believes that more can be done, especially in light of the recent fraud at PFG and its impact on public confidence. CME believes that the regulators and industry need to carefully weigh the costs and benefits of even the most far-reaching proposals that might enhance protection for the segregated funds of our customers.

Some have suggested creating an industry-funded insurance program covering fraud and failure losses, possibly supplemented by privately arranged insurance. Such a program would certainly boost confidence but needs to be balanced against known negatives. It is likely to be cost prohibitive and ineffective given the size and scope of the accounts in our business, and may encourage the "moral hazard risk" that comes into play when customers feel they don't need to worry about their choice or stability of their FCMs.

We need to develop procedures and systems that give regulators direct, real time access to customer segregated account balances, and, as stated above, the SRO Committee is working to do so.

And, while it will be controversial and perhaps have disruptive consequences, we should explore whether customer property not required as collateral at clearing houses should, nonetheless be held by clearing houses or other custodians (while returning interest earned on that money back to the FCMs) and whether safeguards should be put in place to limit the ability of FCMs to transfer such property except to authorized recipients. We believe a look at these proposals in conjunction with our other efforts is necessary to restore public confidence in the derivatives markets while preserving the operating model for the vast majority of firms who respect and comply with the rules.

Finally, while we expect that the misconduct of MFG and PFG will renew calls to eliminate the role of exchanges and clearing houses in auditing and enforcement of their members, we do not believe that a legitimate case can be made to transfer these responsibilities to a government agency. Our regulatory systems are resilient, adaptive to address the challenges and efficient. The next section of my testimony focuses on why it is more important than ever to not only retain, but strengthen the self-regulatory structure.

Current Regulatory Structure Should Not Be Abandoned

Some critics suggest that the current regulatory framework is somehow to blame for MFG's and PFG's misconduct. As further detailed in the discussion below, "self-regulation" in the context of futures markets regulation is a misnomer, because the regulatory structure of the modern U.S. futures industry is in fact a comprehensive network of regulatory organizations that work together to ensure the effective regulation of all industry participants.

The CEA establishes the Federal statutory framework that regulates the trading and clearing of futures and futures options in the United States, and following the recent passage of the Dodd-Frank Wall Street Reform and Consumer Protection Act, its scope has been expanded to include the over-the-counter swaps market as well. The CEA is administered by the CFTC, which establishes regulations governing the conduct and responsibilities of market participants, exchanges and clearing houses.

With respect to MF Global, CME was the designated self-regulatory organization ("DSRO"). As MFG's DSRO, CME was responsible for conducting periodic audits of MFG's FCM-arm and worked with the other regulatory bodies of which the firm is a member. Some critics have suggested that the failure of MFG demonstrates that the current system of front line auditing and regulation by clearing houses and exchanges is deficient because of conflicts of interest. However, there is no conflict of interest between the CME Group's duties as a DRSO and its duties to its shareholders—both require that it diligently keep its markets fair and open by vigorously regulating all market participants.

Federal law mandates an organizational structure that eliminates conflicts of interest. In addition, we have very compelling incentives to ensure that our regulatory programs operate effectively. We have established a robust set of safeguards designed to ensure these functions operate free from conflicts of interest or inappropriate influence. The CFTC conducts its own surveillance of the markets and market participants and actively enforces compliance with the CEA and Commission regulations. In addition to the CFTC's oversight of the markets, exchanges separately establish and enforce rules governing the activity of all market participants in their markets. Further, the NFA, the registered futures association for the industry, establishes rules and has regulatory authority with respect to every firm and individual who conducts futures trading business with public customers. The CFTC, in turn, oversees the effectiveness of the exchanges, clearing houses and the NFA in fulfilling their respective regulatory responsibilities.

In summary, the futures industry is a very highly-regulated industry with several layers of oversight. The industry's current regulatory structure is not that of a single entity governed by its members regulating its members, but rather a structure in which exchanges, most of which are public companies, regulate the activity of all participants in their markets—members as well as non-members—complemented with further oversight by the NFA and CFTC.

CME Group is committed to working with Congress, CFTC, NFA, FIA and market participants to re-evaluate the current system to find solutions to further protect customer funds at the FCM level, and to restoring confidence in derivatives markets. Finding solutions continues to be or highest priority. We are prepared to lead.

Dodd-Frank

Turning to Dodd-Frank, as the CFTC and other regulators finalize the rules implementing the statute, CME Group continues to work with the CFTC to ensure that these rules promote the fundamental principles of Dodd-Frank without compromising the growth and strength of the robust and globally competitive U.S. derivatives markets. For example, statutory Core Principle 9 was written by Congress to apply flexibly, allowing all DCMs to develop their means to achieve a "competitive, open and efficient market and mechanism" for trading. The CFTC's current rule proposal to implement Core Principle 9 would impose a rigid rule that will require an arbitrary percentage of transactions (now set at 85%) to take place on the central order book of an exchange regardless of the underlying products, the market characteristics or the *bona fide* needs of customers. At the CFTC's recent roundtable on this proposal, every market participant opposed the rule as proposed and expressed strong concerns about the proposal's implications. The rule would make it impossible for U.S. futures exchanges to develop new products, force futures exchanges to delist hundreds of successful products, and force trading into unregulated, less regulated or foreign markets with less transparency. Moreover, the proposal would exponentially increase the trading costs, market risk and adverse regulatory and tax consequences for market users, which costs ultimately will be reflected in commodity prices. We urge the Commission to consider this consensus assessment, and avoid adopting any rule under Core Principle 9 that would have the adverse effects stated above.

With respect to the reporting of cleared swaps data, the Commission should allow for implementation of a clearing regime that permits clearing houses to choose the Swap Data Repository to which it must report, including their own affiliated SDR. Doing this will make it possible for SDRs to be up and running for cleared swaps almost immediately, which would be in the greatest interest of not only the regulators seeking to implement the statute, but also the marketplace seeking the most efficient and cost-effective mechanism with which to comply. The CFTC-adopted regulatory reporting regime does not appropriately utilize the existing infrastructure available in derivatives clearing organizations ("DCOs") as far as cleared trades are concerned. Any system that requires a DCO that clears a swap trade to make reports to an external non-DCO data warehouse is inefficient, costly and unnecessary. A much better approach is to build reporting requirements that ensure that the DCO that clears a swap trade houses the complete set of non-public swap information. This is the lowest cost and least burdensome method for implementing regulatory reporting requirements and it can be implemented quickly. It is also the best way to ensure regulators have access to the most accurate swap information including the ability to view the true positions of market participants.

Thank you for the opportunity to testify before the Committee today and for the Committee's continued strong oversight of the implementation of this seminal statute.

Mr. CONAWAY. Thank you, Mr. Duffy.

Mr. Roth, 5 minutes.

STATEMENT OF DANIEL J. ROTH, PRESIDENT AND CHIEF EXECUTIVE OFFICER, NATIONAL FUTURES ASSOCIATION, CHICAGO, IL

Mr. ROTH. Thank you, Congressmen. My name is Dan Roth and I am the President of National Futures Association. As has been noted earlier, this is the second time in 9 months that we are involved with a fraud involving an FCM's misuse of customer segregated funds.

In the Peregrine case, it has resulted in a shortfall of customer segregated funds of approximately $200 million. This fraud was achieved through a sea of forged documents. Peregrine was required to report daily to NFA on the amount of customer funds that it was holding and where those funds were being held. Those reports were false and they were supported by forged daily bank activity statements, forged monthly statements, forged acknowledgment letters, forged deposit slips, forged cashier's checks and forged bank confirmations.

We began our most recent exam of Peregrine in mid-June. When we began that examination, we informed the firm that we were switching the way that we had done bank confirmations, that we were switching to what Terry referred to as the *Confirmation.com.* We were switching to a web-based e-confirmation process. In the past, we had used a traditional bank confirmation process in which the firm would sign an authorization to the bank authorizing the bank to release information to NFA. We would then take that signed document from the firm and mail it directly to the bank, and the bank would then mail a response to NFA and then we would compare the bank's numbers to the numbers that had been provided by the firm.

As part of the e-confirmation process that we switched to, we told the firm that they would authorize the firm's participation in that process. Mr. Wasendorf Sr. executed the necessary authorization on Sunday, July 8th, and the next day attempted suicide. We were immediately contacted by the firm, by Peregrine. They contacted both NFA and the CFTC, and we had conference calls immediately. As of the previous Friday, the firm had reported to us that it was holding approximately $380 million in customer segregated funds with a little over ½ of that being held at U.S. Bank, the Cedar Falls branch office of U.S. Bank.

During the teleconferences on Monday, we had the branch manager of the bank on the phone, and he told us that the actual balance in the account as of Friday was approximately $5 million. We also then reviewed with him—we told him that we had signed bank confirmations from our two previous audits in front of us and we went over with him the balances for each of those two dates. We told him the balances that had been reflected on the dates for which we had written confirmations, and he confirmed for us that those confirmations were false.

It is clear, after both MF Global and Peregrine, certain facts are abundantly clear to all of us. Number 1, customers have to know that their money is safe. Number two, it is up to the regulators to provide the highest level of assurance that we can that their money is safe, and that is both government regulators and self-regulators. Number three, NFA followed standard audit steps and audit procedures in conducting our exams of Peregrine, and number four, that doesn't matter. The fact is, the Generally Accepted Audit Standards, the standard practices, weren't good enough. They didn't catch this fraud. We didn't uncover the fraud for longer than we would have liked. We have to do better.

We began the process of trying to find ways to do better immediately after MF Global. We formed two committees. We formed an SRO committee and we formed a special committee of our public directors, and both of those committees worked on a package of rules that Mr. Duffy referred to that were presented to our board of directors in May and that are described in my written testimony. But we also began working on the second wave of rules because we recognize that we had to make better use of technology to monitor our members' compliance with the rules. So we have a rule that has been in development and that is going to our August board meeting that will require all FCMs to provide direct online access, view-only access to their DSRO of all customer seg bank balances. With that authority, we will be able to check bank confirms or basically conduct bank confirms, check those balances on our own without the firm, without the bank. We can do it for any FCM and for any bank account that we want to.

But we want to go beyond that. What we are actually going to try to build is a system which will take the e-confirmation process that uncovered this fraud and basically make that a daily event. We intend to build a system in which all seg depositories will report on a daily basis to NFA on the funds that they are holding and then on an automated basis will do a comparison between that and what the firms are reporting to us and generate alerts for any suspicious discrepancies.

Mr. Chairman, it is another obvious point, I guess, that we will never be able to completely eliminate fraud but we have to strive for that. That is what we strive for. That is what we are working on. That is what we have been working on all along but with renewed effort after MF Global. We will continue that process. We look forward to working with the Commission, the industry, the Congress and hopefully together we can continue to try to make things harder and harder so that these frauds do not occur in the future.

Thank you, Mr. Chairman. I would be happy to answer any questions.

[The prepared statement of Mr. Roth follows:]

PREPARED STATEMENT OF DANIEL J. ROTH, PRESIDENT AND CHIEF EXECUTIVE OFFICER, NATIONAL FUTURES ASSOCIATION, CHICAGO, IL

Thank you, Mr. Chairman. My name is Daniel Roth and I am the President of National Futures Association. For years the futures industry has built an impeccable reputation for safeguarding customer funds deposited at FCMs in connection with futures trading. Now, for the second time in just 9 months, we are dealing with a shortfall in customer segregated funds at an FCM. Once again, customers have suffered real harm, the type of harm that all regulators attempt to prevent.

The full facts are not yet known, but it appears that Peregrine's customer losses are the result of an elaborate fraud achieved through a set of forgeries and falsities rooted in both the firm's external and internal financial records. Forged external records included bank statements, bank confirmations, print-outs of daily online summary reports of bank balances, cashier's checks, bank acknowledgement letters, bank deposit tickets and bank receipts all purportedly from U.S. Bank. The firm's internal financial records, including daily and month-end account reconciliations, general ledgers and trial balances were also false to the extent they were based on forged U.S. Bank records. Moreover, Peregrine submitted to NFA false daily segregation reports, monthly financial statements and segregated investment detail reports, and annual certified financial statements. Even the firm's customer statements were false to the extent the firm led customers to believe that sufficient assets were on deposit to cover customers' liabilities.

I would like to review for this Committee the recent chronology of events surrounding the Peregrine fraud, the fundamental changes that need to be made in the way we protect customer funds and monitor firms for compliance with the rules, how we are going to make those changes and the steps we have already taken.

NFA began an examination of Peregrine in mid-June. During the audit, we informed Peregrine staff that NFA was changing its method for obtaining bank confirmations to a web-based e-confirmation process. We had completed the necessary data entry for this process by the first week in July, and told Peregrine staff that the firm must authorize its participation in the e-confirmation process. On Sunday, July 8, Mr. Wasendorf, the Chairman of Peregrine, provided the required authorization that was sent to him a week earlier. The next day he attempted suicide.

As of the close of business on July 6th, the previous Friday, Peregrine had reported to us that the firm was holding approximately $380 million in customer segregated funds, with just over ½ of that amount on deposit at U.S. Bank. On July 9th, Peregrine notified the CFTC and NFA of Wasendorf's attempted suicide and we immediately joined in a teleconference with Peregrine staff. We directed firm personnel to go to the bank and have the bank manager join the conference call to confirm the balances as of the previous Friday. The bank manager informed us that the actual balance in the account was approximately $5 million.

We then asked about the balances on the dates for which NFA had received written bank confirmations in our two most recent audits—in 2010 and 2011. Those bank confirmation requests had been mailed by NFA to the P.O. Box on the purported bank acknowledgment letter we had received for the customer segregated account. (In our experience, it is not at all uncommon for banks holding customer segregated funds to use P.O. Boxes to receive confirmation requests since it is a means for them to control the vast amount of paperwork they receive.) In this case, the bank manager informed us that the balances reflected on the two most recent confirmations received by NFA in 2010 and 2011 were similarly inflated.

NFA immediately issued an emergency Member Responsibility Action, freezing the firm's accounts and restricting it to trading for liquidation only. That night the firm's clearing FCM issued margin calls that were not met and began liquidating open positions. The next day the CFTC filed its injunctive action and the firm filed its bankruptcy petition. By then approximately 98% of customer futures positions had been liquidated.

This is certainly not the first time that NFA has taken emergency action in a fraud case involving forgery. We issue eight to ten Member Responsibility Actions per year, most after detecting some form of fraud, many of them Ponzi schemes. In most cases we uncover the fraud relatively quickly and close the firm before the losses mount too high. In a few cases, though, we have uncovered major frauds involving well over $100 million. Several of our cases, both large and small, have involved forged bank documents that were identified by our staff. What sets this case apart is that it involves a registered FCM, an elaborate, pervasive and convincing level of forgeries, and worst of all the loss of segregated customer funds.

This most recent case is an extremely painful reminder of the lessons we learned, and have acted on, after MF Global. The following points are clear:

- For our markets to thrive, customers must know that their funds are safe.
- It is the job of the regulators, both government regulators and SROs, to provide the public with the highest level of assurance possible.
- NFA followed audit steps developed by the Joint Audit Committee that were consistent with CFTC Financial and Segregation Interpretation No. 4–1 in all of our examinations of Peregrine. But to assure ourselves of that, a committee of our public directors has directed the commission of an internal review of our audit practices and procedures, and the execution of those procedures in the specific instance of Peregrine.
- Notwithstanding that, and notwithstanding it was NFA's actions that uncovered this fraud in our most recent exam, the simple fact is that Wasendorf's forgeries fooled us, and fooled us for longer than any of us would like.
- Our audit steps alone are not good enough anymore. We are implementing better ways to monitor members for compliance, especially with regard to customer segregated funds, and are looking for even more ways to improve monitoring of firms for compliance with the rules.

Shortly after the demise of MF Global, we formed an SRO Committee with the CME and representatives of other exchanges, including ICE, the Kansas City Board of Trade and the Minneapolis Grain Exchange. As discussed below, the SRO Committee developed a number of rule proposals that have already been approved by our Board. Early on in its deliberations, the committee recognized that we need to make better use of technology to monitor firms for compliance with segregation requirements.

The committee has developed a proposed rule that will be presented at NFA's August Board meeting that would require FCMs to provide online, view-only access to bank balances for customer segregated and secured amount accounts to the firm's designated SRO. We understand the CME will adopt the same rule. Under this rule, SROs will be able to check any customer segregated bank account balance for any FCM any time, without asking the firm or the bank, and compare those balances to the firm's daily segregation report. NFA intends to expand this approach, once it is implemented, to receive daily reports from all depositories for customer segregated accounts, including clearing FCMs. We will develop a program to compare these balances with those reported by the firms in their daily segregation reports. While there may be reconciling items due to pending additions and withdrawals, the system will generate an immediate alert for any material discrepancies.

We have also agreed with the CME to perform an immediate confirmation of all customer segregated bank accounts for all of our FCM Members using the e-confirmation process I referred to earlier. The completion of this work within the next week or so should help ensure that another Peregrine is not lurking in the industry.

All of this is in addition to the rule changes already approved by NFA's Board in May and just recently approved by the CFTC. Those changes include rules requiring that:

- All FCMs must report certain information concerning the FCM's financial condition that will then be made available to the public on NFA's website. This information includes the firm's capital requirements; its excess capital; the amount of customer segregated funds held by the firm; the amount of excess segregated funds maintained by the firm; whether the firm engages in proprietary trading, once that term is defined in the context of the Volcker rule; and whether any custodial bank holding customer funds is an affiliate of the FCM.
- All FCMs must report to NFA detailed information on how customer segregated funds are invested, and that information will also be made available to the public through NFA's website.
- If any FCM reduces its level of excess segregated funds by 25% in any one day by making disbursements that are not for the benefit of customers, a financial principal of the firm must approve the disbursement, must immediately notify the firm's DSRO, and must certify that the firm remains in compliance with all segregation requirements.

All of these rule changes promote greater transparency for both customers and regulators and should help prevent a recurrence of the type of problems we saw at MF Global. These rule changes, however, are only the beginning. The MF Global and Peregrine customer losses are a painful reminder that we must continuously improve our surveillance, audit and fraud detection techniques to keep pace with changing technology and an ever-more-complicated financial marketplace.

Mr. Chairman, for so long as there have been financial markets, there has been fraudsters who attempt to steal other people's money, and no regulator can provide assurance that fraud can be completely eliminated. But this is the second time in 9 months that customers have suffered losses due to misconduct or fraud on the part of an FCM, and when customers suffer those devastating losses, it is also devastating for the industry. We know that we can never completely eliminate fraud, but we must continue to adopt rules and surveillance techniques to try to eliminate the possibility that this could happen again. The steps we took at our May Board meeting and the proposed steps outlined above are a start in that process. We look forward to working with Congress, the Commission and the industry to achieve that goal and no ideas should be off the table in this process.

Mr. CONAWAY. Thank you, Mr. Roth.

Mr. Lukken for 5 minutes.

STATEMENT OF HON. WALTER L. LUKKEN, PRESIDENT AND CHIEF EXECUTIVE OFFICER, FUTURES INDUSTRY ASSOCIATION, WASHINGTON, D.C.

Mr. LUKKEN. Thank you, Chairman Conaway and Members of the Committee. I testify today on behalf of the Futures Industry Association, the leading U.S. trade association for futures, options and cleared derivatives in the United States.

We now know that over $200 million in customer funds is missing from Peregrine Financial and that the fraud appears to date back 20 years. On the heels of the MF Global collapse, this is appalling and absolutely devastating news in our industry, and most of all, customers who are the victims of this egregious fraud.

In the futures industry, we took considerable pride in the knowledge that the regulated futures markets had come through the financial crisis of 2008 with relatively few problems. During those difficult weeks, the futures markets continued to operate without significant incident to manage the volatile risks stemming from the financial crisis and to discover transparent prices when confidence was lost in the over-the-counter markets.

Today we can no longer say the futures markets came through these times unblemished. The failures of MF Global and Peregrine Financial are a stark reminder that diligent efforts by regulators and the firms themselves are essential to prevent losses to customers from mismanagement and fraud.

The industry and regulators have already taken a number of important steps in the wake of the MF Global collapse. In February, FIA released its initial recommendation for customer funds protection calling on each FCM to adopt certain recommended internal control policies and procedures relating to the protection of customer funds. It is my understanding that the CFTC and the SROs have adopted or are actively considering adopting all of these suggestions. FIA has also taken efforts to educate customers. In February, we issued FAQs for customer fund protections which is being used by the FCMs to provide their customers with increased disclosure on how customer funds are secured.

However, the recent events involving Peregrine make it evident that more must be done. In this respect, I would like to discuss the FIA's transparency initiative that I announced last week. First, FIA strongly supports providing regulators with the independent ability to electronically review and confirm customer segregated balances across every FCM at any time, period.

Second, FIA supports the creation of an automated confirmation process for segregated funds that will provide regulators with the timely information that customer funds are secure. Technology solutions can help prevent this type of event from occurring again.

Third, FIA supports the creation of an FCM informational portal that will centrally house firm-specific financial and related information regarding FCMs so customers can more readily access material information when evaluating an FCM.

Fourth, FIA recommends that FCMs publicly certify as soon as practicable that they are in compliance with the initial recommendations for customer funds protections that FIA issued in February and that I referred to earlier.

I was encouraged by Chairman Gensler's remarks that the Commission will be supporting and adopting many of these sensible industry recommendations. The blocking and tackling of regulation depends on ensuring that firms have proper internal risk controls in place and that these are independently reviewed and verified. Those basics of smart regulation have not changed over time, and we look forward to working with the Commission to prioritize initiatives aimed at protecting customers.

Turning now to Dodd-Frank, FIA has been an active participant in the rulemaking process undertaken by the Commission over the last 2 years filing over 50 comment letters during that time. Having run a derivatives clearinghouse, I understand the difficulty in complex system builds, and Dodd-Frank indeed is that. The key to any major project implementation is prioritization and sequencing. The industry would greatly benefit from the Commission prioritizing the critical rules that must be in place and developing a sequencing of those critical rules to bring certainty of planning to many of our firms. In fact, the SEC has done just that with the publishing of its Implementation Policy Statement aimed at avoiding, "the disruption and costs that could result if compliance with all rules where required simultaneously or haphazardly."

Unless the Commission acts to establish a well-designed implementation policy, a significant number of rules will come into effect in the next few months in a haphazard manner, imposing a substantial burden on the market participants and exposing the industry to potential market disruption. These challenging times have also been compounded by the Commission's decision to move forward concurrently with significant rule proposals that are not mandated by Dodd-Frank such as Core Principal 9 on centralized trading and the redesign of the ownership and control reports at a cost of $18.8 million per firm in the industry.

Of the Dodd-Frank rules that are critical, and there are many, one of the most important is the recent publication of proposed Commission guidance on the cross-border application of certain swap provisions. This guidance is not a rule under the APA and therefore does not require the Commission to conduct a cost-benefit analysis. It is evident, however, that its cost may be considerable, given the guidance's broad interpretation of the definition of *U.S. person* and, "activities that would be deemed to have a direct and significant connection with commerce in the United States." The result would be a complex and confusing regulatory regime that would expose U.S. FCMs and swap dealers to consider regulatory risk and would extend the CFTC's reach to many jurisdictions around the world. On this theme of prioritization and sequencing, it would be imperative that the CFTC first clarify this guidance before the swap regulations and other Dodd-Frank requirements go into effect.

These are challenging times for our industry, not only due to the regulatory changes described above but also due to the fundamental shift to the business model. With depressed futures volumes, historically low interest rates and ultracompetitive pricing models, FCMs are under tremendous strain financially. Many are concerned that the business is reaching a point where it cannot absorb additional costs and a seismic shift in the model may occur—whether that is a significant consolidation of FCMs or FCMs leaving the business altogether. This would have an unfortunate effect of limiting customer choice and reducing the number of firms that backstop the clearing system, making it vulnerable to catastrophic losses.

So in conclusion, as we consider these regulatory changes, it would be wise to carefully weigh the costs of any new regulatory mandates and concentrate our resources on implementing only the highest priority reforms ahead of all the rest.

Thank you, Mr. Chairman.

[The prepared statement of Mr. Lukken follows:]

PREPARED STATEMENT OF HON. WALTER L. LUKKEN, PRESIDENT AND CHIEF EXECUTIVE OFFICER, FUTURES INDUSTRY ASSOCIATION, WASHINGTON, D.C.

Chairman Lucas, Ranking Member Peterson, and Members of the Committee, FIA is the leading trade organization for the futures, options and over-the-counter cleared derivatives markets. Our membership includes the world's largest derivatives clearing firms as well as leading derivatives exchanges and clearinghouses from more than 20 countries. Our core constituency consists of futures commission merchants (FCMs), those regulated businesses that transact and guarantee the futures trades of customers and end-users. All of our membership is working overtime to implement the many reforms in the Dodd-Frank Wall Street Reform and Consumer Protection Act. Significant progress has been made in finalizing these reforms and I will address the rulemaking process later in my remarks. First, however, I would like to focus my remarks on the recent failure of Peregrine Financial Group (PFG).

We now know that more than $200 million in customer funds is missing and that the falsification of financial records appears to go back 20 years. On the heels of the MF Global collapse, this is appalling and absolutely devastating news for everyone in our industry, and most of all the customers who are victims of this egregious fraud. PFG was not a big firm, but its demise resonates throughout the industry.

In the futures industry, we took considerable pride in the knowledge that the regulated futures markets had come through the financial crisis of 2008 with relatively few problems. During those difficult weeks, the futures markets continued to operate without significant incident to manage the volatile risk stemming from the financial crisis and to discover transparent prices when confidence was lost in the pricing of the over-the-counter markets. The regulated futures markets, and the regulatory regime that underpins them, became the foundation of mandated swap clearing of Title VII of the Dodd-Frank Act.

We can no longer say that the futures markets came through these times unblemished. The failures of MF Global and Peregrine Financial Group are a stark and unwelcome reminder that, no matter how well designed a regulatory structure may be, diligent and sustained efforts by regulators and the firms they regulate are essential to prevent losses to customers from mismanagement or fraud.

In addition to the losses suffered by Peregrine's customers, the most damaging consequence of Peregrine's fraud is the effect on customer confidence, in particular in the sanctity of customer funds protections provided under the Commodity Exchange Act (Act) and the Commission's rules. This confidence was earned over decades by the many individuals that comprise the regulated futures industry. Unfortunately, one person's conduct has instantaneously shattered this trust and now overshadows the hard work and honorable behavior of everyone else.

At FIA, we understand that it is going to take time to regain public trust and we are committed to doing whatever it takes to restore confidence in the safeguards for customer funds. Doing nothing is not an option.

We also recognize that this is a collective problem, calling for collective solutions. Firms, exchanges, end-users and regulators must work together to identify the additional tools that are needed to protect customer funds and restore confidence and then implement them promptly and efficiently.

Post-MF Global Reforms

The industry and regulators have already taken a number of important steps in the wake of the MF Global collapse to strengthen the customer protection regime in the futures markets. In February, FIA released its *Initial Recommendations for Customer Funds Protection.* These recommendations called on each FCM to adopt and document—to the extent not already in place—internal control policies and procedures relating to the protection of customer funds. In particular, FIA recommended that FCMs maintain appropriate separation of duties among individuals responsible for compliance with customer funds protections and develop a training program for chief financial officers and other relevant employees to help ensure that the individuals responsible for the protection of customer funds are appropriately qualified.

We also recommended and supported rules adopted by the Chicago Mercantile Exchange and National Futures Association that subject all FCMs to enhanced recordkeeping and reporting obligations, including: (i) transmitting daily customer segregation balances to their respective designated self-regulatory organization (DSRO); and (ii) requiring the chief financial officer or other appropriate senior officer to authorize in writing and promptly notify the FCM's DSRO whenever an FCM seeks to withdraw more than 25 percent of its excess funds from the customer segregated account in any day. These changes have now been approved by the Commission.

Another of our recommendations calls on the Commission to require that each FCM certify annually that there are no material inadequacies in its internal controls regarding maintenance and calculation of adjusted net capital and compliance with the rules regarding the protection of customer funds. FIA encourages the Commission to adopt this recommendation as part of its package of audit improvements.

Clearly, these recommendations for strengthening internal controls are relevant to both MF Global and Peregrine Financial. We have witnessed over the years a number of instances where lax auditing controls or a lack of separation of duties related to the movement and protection of customer money have led to wrongful activity and fraud. The adoption of these basic audit and internal control recommendations will go a long way to detect and deter inappropriate behavior, going forward.

FIA also has taken efforts to educate customers on the scope of the protections for their funds so they can make well-informed decisions when choosing where to do business. In February, we issued *Frequently Asked Questions on Customer Funds Protections,* 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. This document continues to be updated as we gather comments from regulators on other areas that should be covered. In addition, we will be expanding this document to ensure that customers have material information when evaluating an FCM.

FIA's Transparency Initiative

Even with all that has been done, the recent events involving Peregrine Financial make it evident that more must be done. In this respect, I would like to discuss the "Transparency Initiative" that I announced last week.

First, FIA strongly supports providing regulators with the independent ability to electronically review and confirm customer segregated balances across every FCM at any time.

Second, FIA supports the creation of an automated confirmation process for segregated funds that will provide regulators with timely information that customer funds are secure. Technology solutions can help prevent this type of event from occurring again.

Third, FIA supports the creation of an "FCM Information Portal" that will centrally house firm-specific financial and related information regarding FCMs so customers can more readily access material information when evaluating an FCM. FIA's board is actively considering ways to construct and populate such a system.

Fourth, FIA recommends that FCMs publicly certify as soon as practicable that they are in compliance with the Initial Recommendations for Customer Funds Protection that FIA issued in February, specifically that they have adopted and implemented the internal control policies and procedures related to the protection of customer funds. These controls should be subject to independent review and oversight by the SROs and independent auditors.

I was encouraged by Chairman Gensler's remarks before the Senate Agriculture Committee last week that the Commission will be supporting and adopting many of these sensible industry recommendations. The "blocking and tackling" fundamentals of regulation depend on ensuring that firms have proper internal risk controls in place and that these are independently reviewed and verified. Those basics of smart regulation have not changed over time, and we look forward to working with the Commission to prioritize initiatives aimed at protecting customers.

Dodd-Frank Rulemaking

Turning now to Title VII of the Dodd-Frank Act, FIA broadly supports the regulatory goals set out therein, which are designed to implement the G20 commitment that:

> *All standardised OTC derivative contracts should be traded on exchanges or electronic trading platforms, where appropriate, and cleared through central counterparties by end 2012 at the latest. OTC derivative contracts should be reported to trade repositories.*

As with the regulated futures markets, centralized trading and clearing of swaps will reduce financial and operational risks of all market participants and bring necessary transparency to this critical segment of our financial system.

FIA has been an active participant in the rulemaking process undertaken by the Commission over the past 2 years, filing more than 50 comment letters and taking part in several Commission staff roundtables. We have also met numerous times with the Commissioners and Commission staff on various issues, which meetings have been reported on the Commission's website.

Our comments have generally been supportive of the regulatory goals, while (i) seeking clarification of the obligations that would be imposed under certain provisions, (ii) noting the operational burdens in complying with others, (iii) raising cost-benefit issues where appropriate, and (iv) recommending alternatives that would achieve the Commission's regulatory goals more effectively and efficiently. Our aim is smarter regulation, not necessarily less regulation.

I should emphasize that our concerns are not limited to swap-related rulemakings. Although the primary focus of Title VII is the over-the-counter swaps markets, the Commission's rules also require FCMs to restructure significantly the way in which they have been conducting their regulated futures businesses for decades and, in the process, to undertake substantial changes to their record-keeping and reporting systems. Several such rules, discussed below, have posed a significant challenge to both FCMs and the Commission.

Large Trader Reports. In July 2011, the Commission published rules requiring large trader reports for swaps and swaptions on physical commodities, which became effective on September 20, 2011. The rules raised a number of questions for which the industry sought guidance from the Commission staff. However, it was not until December 2011 that the staff was able to issue a Guidebook that provided additional guidance and detailed instructions for submitting large swaps trader reports to the Commission. In May 2012, the staff issued a revised Guidebook. Because of broad uncertainty surrounding compliance in this area, the Commission staff has found it necessary to issue temporary relief from the large trader reporting requirements five times.

Position Limits and the Aggregation of Positions. The Commission's rules establishing position limits for 28 exempt and physical commodities generally require that, unless a particular exemption applies, a person must aggregate all positions for which that person controls the trading decisions with all the positions for which that person has a ten percent or greater ownership interest in an account or position, even if the person does not control trading in the other accounts. In May, in response to a petition from the Working Group of Commercial Energy Firms and the Commercial Energy Working Group (Working Groups), the Commission proposed to amend its policy requiring the aggregation of positions. As proposed to be amended, the aggregation policy would permit persons with an ownership that does not exceed 50 percent to file for disaggregation relief, if they can demonstrate independence by meeting Commission-established criteria.

In support of their petition, the Working Groups argued, among other things, that the rules would force information sharing and the coordination of trading between entities that would be contrary to existing best practices for antitrust compliance. Moreover, entities with complex corporate structure arrangements that include established information barriers to ensure compliance with other regulatory requirements would face significant costs to monitor positions on an intra-day basis, notwithstanding the current lack of control over such trading.

FIA supported the Working Groups' petition and is pleased that the Commission has proposed to amend its aggregation policy. Nonetheless, we believe the proposed amendment does not go far enough. The Commission should permit disaggregation without regard to ownership interest when entities can demonstrate separate management and control of trading and positions.

Such a policy is consistent with section 4a of the Act, which calls for aggregation of positions that are subject, directly or indirectly, to common control. Section 4a does not require aggregation of positions arising from common ownership. Such a policy would also recognize commercial reality in an economy in which companies have passive ownership interests in scores, if not hundreds, of companies. Without coordinated trading, there is no increased risk of excessive speculation or manipulation.

A decision on the proposed amendment to the Commission's aggregation policy is only one of several issues on which the industry requires guidance before it can develop the systems necessary to implement the Commission's position limit rules. Other critical open issues include: (i) the scope and logistics of grandfathering existing futures and swaps positions; (ii) the scope of grandfathered risk management positions; (iii) the scope of *bona fide* hedging transactions; and (iv) the unavailability of technology necessary to monitor for compliance with position limits intra-day. To date, however, the Commission has not provided a forum for working through these issues, leaving the industry struggling with how it is to comply with this rule.

Legally Separate Operationally Commingled (LSOC) Rules. More recently, the industry has been meeting with representatives of the several derivatives clearing organizations (DCOs) that clear swaps to discuss the operational issues that arise in implementing the Commission's rules for providing protection for cleared swaps customer collateral.

On their face, these rules, commonly referred to as the LSOC rules, appear relatively straightforward and FIA has supported the adoption of this new framework. Each day, clearing member FCMs must provide to the DCOs at which customer positions are carried information regarding (i) the identity of the customers whose positions make up the omnibus account, (ii) the positions carried on behalf of each customer, and (iii) the value of the margin posted with the DCO that supports each customer's portfolio of positions. Nonetheless, a number of very difficult operational questions have arisen that will take time to resolve. Until they are, there is not enough certainty or consensus on certain fundamental issues to permit FCMs and DCOs to build the systems necessary to implement the LSOC rules, which are scheduled to go into effect in November.

Core Principle 9. Certain pending rules also threaten to have a significant impact on the conduct of regulated futures activities. One such rule is the proposed rule implementing Core Principle 9. This principle requires a designated contract market (DCM) to provide "a competitive, open, and efficient market and mechanism for executing transactions that protects the price discovery process of trading in the centralized market." To implement this principle, the Commission has proposed to prohibit a DCM from continuing to list a futures contract unless at least 85 percent of the volume in such contract is traded through the DCM's centralized order book. If a futures contract no longer met the 85 percent test, the DCM would be required to de-list the contract and either liquidate the open positions or transfer the positions to a swap execution facility.

This simple renaming of the instrument from a future to a swap would have dramatic effects, including substantially increasing the amount of initial margin required by the DCO to open the position and changing the tax treatment of the contract for non-hedge positions. Consequently, as we noted in our comment letter on the proposed rule, adoption of the proposed rule would result in significant legal and regulatory uncertainty and would have the curious effect of placing the regulated futures markets at a competitive disadvantage to the cleared swaps markets. In particular, start-up exchanges and new product offerings would find it difficult to meet this litmus test, thus lessening competition and innovation in the industry. Again, this rulemaking was not mandated by Dodd-Frank and its primary aim is the futures markets, not the swaps market where the financial crisis largely stemmed.

Cross-Border Guidance. More recently, the Commission has published for comment what it has termed interpretative guidance on the cross-border application of certain swaps provisions of the Commodity Exchange Act. The interpretative guidance is not a "rule" under the Administrative Procedure Act and, therefore, does not require the Commission to conduct a cost-benefit analysis before adopting it as final. Although we are still studying its terms, it is evident that the Commission has proposed to adopt a broad interpretation of the definition of a "U.S. person" and of the activities that would be deemed to have "a direct and significant connection with activities in, or effect on, commerce of the United States." The result would be a complex and confusing regulatory scheme that would expose U.S. FCMs and swap dealers to considerable regulatory risk and would effectively extend the CFTC's reach into many jurisdictions around the world. It is imperative that the CFTC clarify this guidance before the registration and other Dodd-Frank requirements go into effect so that firms understand and can plan for the scope of Dodd-Frank's impact on their global businesses.

Implementation Timetable. In light of this complex and legally uncertain regulatory environment, we believe it is essential that the Commission follow the lead of the Securities and Exchange Commission (SEC), which developed and recently published for comment an implementation policy statement. As Robert Cook, the Director of the SEC's Division of Trading and Markets, explained in testimony last week, the policy statement sets out the order in which the SEC expects to require compliance by market participants with the final rules to be adopted under Title VII, with the goal of avoiding "the disruption and cost that could result if compliance with all rules were required simultaneously or haphazardly."

The implementation policy statement divides the final rules to be adopted by the SEC into five broad categories and describes the interconnectedness of the compliance dates of the final rules within each category, and where applicable, the impact of compliance dates of final rules within one category upon those of another category. The statement emphasizes that those subject to the new regulatory requirements arising from these rules will be given adequate, but not excessive, time to come into compliance with them.

This is not a new idea. CFTC Commissioners have urged the Commission to adopt a similar policy statement, as have numerous market participants and trade associations, including FIA. However, time is running out. Unless the Commission acts promptly to establish a well-designed implementation policy, a substantial number of substantive rules will come into effect in the next few months in a haphazard manner, imposing a substantial burden on the industry and exposing the industry to significant risk of enforcement proceedings. In this latter regard, in order to assure that market participants acting in good faith to comply with these rules are not unnecessarily exposed to the threat of enforcement action, it is essential that the Commission provide all market participants with "adequate, but not excessive, time to come into compliance" with these rules.

I want to point out that the challenges that the industry is facing in implementing the Dodd-Frank Act have been exacerbated by the Commission's decision to move forward concurrently with significant rule proposals that are unrelated to the Dodd-Frank Act. I have already mentioned the Core Principle 9 rulemaking, which was not a mandated rule by Dodd-Frank. Another such proposal is the Commission's proposal to require DCMs and other reporting entities to file ownership and control reports (OCR) to the Commission on a weekly basis. As originally proposed, the OCR rules would have required FCMs to collect and report a substantial amount of information that either is not collected in the manner the Commission anticipated or is not collected at all. As a result, the proposed rules would have required a complete redesign of the procedures, processes and systems pursuant to which FCMs create and maintain records with respect to their customers and customer transactions.

To prepare our comment letter on the proposed OCR rules, FIA formed an OCR Working Group to analyze their potential impact. We found that the median firm would face total costs of roughly $18.8 million and ongoing costs of $2.6 million annually. These costs, combined with the unwarranted structural change in the conduct of business among U.S. futures markets participants that the proposed rules would require, could force a number of FCMs to withdraw from the business and raise the barrier to entry for potential new registrants.

In its comment letter, FIA presented an alternative OCR proposal that we believe would achieve the essential regulatory purposes of the Commission's proposed rules. The cost of the alternative OCR was considerably less than the estimated cost of implementing the OCR rules, but they are substantial nonetheless. FIA and the DCMs continued talking with Commission staff following the comment period. The Commission recently proposed a revised OCR structure that we understand is closer to the alternative that the industry recommended. We look forward to analyzing the proposal.

We must emphasize that the FIA alternative was not developed within the 60 day comment period originally proposed by the Commission. It took several months of detailed analysis by industry representatives who otherwise perform critical operational and risk management responsibilities in their firms. We also want to emphasize that the OCR rule exemplifies a broader problem; the firms are being overwhelmed with the volume and complexity of the record-keeping and reporting programs they are being asked to implement in a very short time frame.

Another rulemaking not directly mandated by Dodd-Frank is the Commission's recent adoption of rule 1.73 requiring clearing member FCMs to establish risk-based credit limits for all customers and implement procedures to screen all orders for compliance with these limits prior to execution. In particular, an FCM would be required to screen by automated means all orders received or executed by automated means. However, no systems currently employed by, or available to, clearing member FCMs, or the DCMs on which the trade may be executed, permit a trade to be screened prior to execution for its potential effect on the customer's existing portfolio of positions. Risk management systems are designed to monitor a customer's risk on a post-execution/post-cleared basis. Moreover, the rule appears to require significant changes in the operational and contractual relationships among clearing member FCMs, executing brokers and investment managers as well as substantial systems changes.

FIA is requesting the Commission staff to clarify the intended scope of the rule, and we are hopeful that the staff will approve an interpretation of the rule that will be technologically practicable, while meeting the Commission's regulatory goals.

Conclusion. These are challenging and difficult times for our industry, not only due to the regulatory changes described above but also due to fundamental shifts in the business model that underlies the futures industry. With depressed futures volumes, historically low interest rates, and an ultra-competitive pricing model, FCMs are under tremendous strain financially. Many are concerned that the business is reaching a point where it cannot absorb additional costs without a seismic shift in the model—whether that is significant consolidation among FCMs or FCMs leaving the business altogether. This would have the unfortunate effect of limiting customer choice and reducing the number of firms that backstop the clearing system, making it more vulnerable to catastrophic losses. So as we consider regulatory changes, it would be wise to carefully weigh the costs of any new regulatory mandates and concentrate our resources on implementing the highest priority reforms ahead of all the rest.

As discussed above, the industry is working against a short deadline while faced with considerable uncertainty about how the Commission plans to implement a wide swathe of its rules and how those rules will fit in a global regulatory structure. As we move forward, it is essential that the unintended consequences of any reforms be eliminated and the many positives that this industry has delivered to the customers of our markets be preserved.

Thank you and I will be happy to answer any questions.

Mr. CONAWAY. Mr. Lukken, thank you.

Mr. Heck for 5 minutes.

STATEMENT OF JOHN M. HECK, SENIOR VICE PRESIDENT, BUSINESS DEVELOPMENT, THE SCOULAR COMPANY; MEMBER, EXECUTIVE COMMITTEE AND BOARD OF DIRECTORS, NATIONAL GRAIN AND FEED ASSOCIATION, OMAHA, NE

Mr. HECK. Thank you, Mr. Chairman and Members of the Committee. I am John Heck, Senior Vice President of the Scoular Company. I appear today testifying on behalf of the National Grain and Feed Association. We appreciate the opportunity to appear before the Committee today.

I serve as Co-Chairman of the NFGA's MF Global Task Force, which was formed to develop responses and recommendations in response to the failure of MF Global. Many NGFA member firms have been deeply affected by the liquidation of MF Global. Customer accounts were frozen, then transferred to other FCMs in chaotic fashion and with a dearth of information to customers so they could possibly manage their financial exposure. These customer funds were required to be segregated and held safe by MF Global. We believed for years that segregated customer funds were completely safe but now we see that was not the case. The unprecedented loss of customer funds has led to a loss of confidence in futures markets.

Our task force asked the question: was MF Global a one-time situation or is the level of customer risk still significant? Unfortunately, we know today that serious risk still is present. The apparent long-term fraud and misappropriation of customer funds at Peregrine Financial Group highlights the need for more effective regulatory oversight and enhanced safety for customer funds. The cumulative effect of MF Global and now the PFG failure, especially at a time when regulators were on heightened alert, has been a huge loss of confidence in regulators and in the rules that protect customers. We believe steps should be taken to help restore confidence and improve customer protection now.

In early April, the NGFA submitted preliminary recommendations to the CFTC for enhanced reporting, transparency and accountability. Those recommendations are attached to my written testimony in addition to a second set of recommendations we submitted last month to leadership of the House and Senate Agriculture Committees. I would like to highlight several of these today.

The Commodity Exchange Act, CFTC regulations and the Bankruptcy Code should be harmonized for greater clarity and to avoid interpretative inconsistencies. Second, strengthen the CFTC's authority to appoint a trustee who exclusively represents the interests of commodity customers in a bankruptcy. Third, the Bankruptcy Code should state clearly that customers with segregated funds always are first in line for distribution of funds. Fourth, the Bankruptcy Code should include authority for commodity customer committees in an FCM liquidation. And last, safe-harbor provisions of the Bankruptcy Code should not limit powers of a trustee to recover customer funds. Reforming the Bankruptcy Code is a major undertaking. We would welcome working with other organizations that have similar goals so Congress can act on legislation soon.

The NGFA also recommends establishment of a new type of voluntary account structure that fully segregates customer assets. Full segregation will result in additional costs so we suggest the use of such accounts would be on a voluntary basis at the agreement of an FCM and its customers. We believe that a pilot program could be implemented quickly and without legislation, and we would find a useful way to test the mechanics of this new account structure and begin to judge its true costs and benefits.

Because full segregation might not be attractive to all customers, the NGFA also recommends that insurance coverage be extended to commodity futures customers in much the same way that insurance protection now exists for securities customers under the SIPC.

I would like to close my testimony with some comments about a proposed rule by the CFTC that has generated serious and widespread concern among NGFA member firms and agricultural producers. It has also been mentioned by a Member of the Committee this morning. It would require that any member of a designated contract market like the Chicago Board of Trade or the Kansas City Board of Trade record all oral communications that could lead to a cash transaction and keep records for CFTC inspection for 5 years. Many country elevators would be required to record telephone conversations with farmers about possibly entering into a forward cash contract to purchase the farmer's grain, even though forward contracts are specifically exempted in the Commodity Exchange Act from CFTC's jurisdiction. This proposal would require substantial new investment in communications technology for many small businesses. In addition, it would create a bifurcated cash marketplace in which some grain purchasers would be required to record communications and maintain records while others would not be covered by the rule. We are happy to hear the Commissioner's comments this morning that he may be able to dial back on those requirements.

Thank you for the opportunity to share the views of the National Grain and Feed Association. I would be happy to respond to any questions.

[The prepared statement of Mr. Heck follows:]

PREPARED STATEMENT OF JOHN M. HECK, SENIOR VICE PRESIDENT, BUSINESS DEVELOPMENT, THE SCOULAR COMPANY; MEMBER, EXECUTIVE COMMITTEE AND BOARD OF DIRECTORS, NATIONAL GRAIN AND FEED ASSOCIATION, OMAHA, NE

Good morning, Chairman Lucas, Ranking Member Peterson, 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.

This morning, I am testifying on behalf of the National Grain and Feed Association (NGFA), the national trade association representing grain elevators, feed manufacturers, processors and other commercial businesses that utilize exchange-traded futures contracts to hedge their risk and to assist producer in their marketing and risk management strategies. We appreciate the opportunity to testify before the Committee today.

I serve on the NGFA's Executive Committee and Board of Directors, and I also serve as Chairman of the Association's Finance and Administration Committee. More recently, I was asked to co-chair the NGFA's MF Global Task Force, formed to develop responses and recommendations to the failure of MF Global. Our priorities are to advocate regulatory and policy changes that will help ensure that another similar situation does not recur and to enhance protections for commodity futures customers.

Many NGFA-member firms have been deeply affected by the MF Global Holdings bankruptcy and the subsequent liquidation of futures commission merchant (FCM) MF Global Inc. Following the bankruptcy, customers' accounts were frozen, then transferred to other FCMs in chaotic fashion and with a dearth of information to help customers manage their financial exposure. Today, another distribution of funds from the MF Global trustee has begun with the goal of bringing all commodity customer distributions to about 80% of account value, but many firms still have received only 72% of their funds with no assurance they ever will be made whole.

It is worth emphasizing again that these customer funds were required to be segregated and held safe by MF Global. Our industry had believed for years that segregated customer funds were completely safe, but we now see that was not the case. The unprecedented loss of customer funds in the MF Global debacle has led to a loss of confidence in futures markets and in the ability of the current system to protect customer funds.

As our Task Force considered regulatory and policy changes in the aftermath of MF Global, we asked ourselves: "Was MF Global a one-time situation, or is the level of customer risk still significant? Did the MF Global failure and its consequences rise to the level that merited significant change?"

Unfortunately, we know today that serious risk still is present. The discovery of apparent long-term fraud and misappropriation of customer funds at Peregrine Financial Group (PFG) highlights again the need for more effective regulatory oversight and meaningful change that will provide additional safety for customer funds both before a failure occurs and in the event of future FCM liquidations.

We are still awaiting details of the situation surrounding the PFG situation. On its face, the PFG failure appears to have some key differences from MF Global—namely, that customer funds were intentionally misappropriated for a variety of illegitimate purposes over a very long period of time. However, the cumulative effect of MF Global and PFG failures within a relatively short time—and especially the failure of PFG at a time when regulators presumably were on heightened alert for problems—has been a huge loss of confidence in regulators and in the adequacy of current rules to protect customer funds. We look forward to a full explanation by regulators of exactly what happened at PFG. In the meantime, we believe there are steps that should be taken to begin restoring confidence and to bolster protections for segregated customer funds.

In early April, the NGFA submitted to the Commodity Futures Trading Commission (CFTC) preliminary recommendations for enhanced reporting, transparency and accountability. Generally, these recommendations were developed with the intent of assisting customers by providing them with more information to evaluate FCMs with whom they do business. In addition, several of our recommendations were aimed at requiring greater scrutiny by the CFTC and self-regulatory organizations of FCM practices and financial reporting, and requiring FCMs to develop and adhere to policies and procedures that rigorously will ensure proper safeguarding of customer funds. Those recommendations are attached, and I would be happy to discuss them in greater detail.

Late last month, the NGFA submitted a second set of recommendations to leadership of both the Senate and House Agriculture Committees. These recommendations involve significant changes in customer account structure, reforms to the U.S. Bankruptcy Code to enhance customer rights and protections, and the potential extension of insurance coverage to commodity futures customers. The NGFA's letter transmitting our latest recommendations is attached, and I would like to highlight several of our recommendations today:

Reforms to the U.S. Bankruptcy Code

- The Commodity Exchange Act, CFTC regulations and the Bankruptcy Code should be harmonized to provide greater clarity and avoid interpretive inconsistencies in the event of future FCM liquidations.
- The CFTC's authority to appoint a trustee to represent exclusively the interests of commodity customers should be strengthened. In a situation like MF Global, where over 95% of assets and accounts affected were those of commodities customers, we believe the CFTC should play a larger role and that a trustee with commodities expertise should be involved.
- 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 of affiliates should go to reimburse segregated customer accounts first.
- The Bankruptcy Code clearly should state authority for establishment of commodity customer committees to represent their interests in an FCM liquidation.
- Regardless of the intent behind transfer of customer funds, "safe harbor" provisions of the Bankruptcy Code should not limit powers of a trustee to recover customer funds.

We understand that significant reforms to the U.S. Bankruptcy Code are a major undertaking. For that reason, the NGFA would welcome working together with other organizations that have similar goals in order that legislation can be moved expeditiously by Congress.

Fully Segregated Customer Accounts

Current legal authority provides for *pro rata* distribution by the trustee of customer property that was held by a failed FCM. That means that all customers must share equally in losses in the event of a shortfall of funds. The NGFA recommends establishment of a new type of account structure for use by FCM customers on a voluntary basis that provides for full segregation of customer assets, not commingled with FCM funds or other customer funds. It will be important in establishing a new fully-segregated structure that customer funds not fall under the "customer funds" definition in the Bankruptcy Code, thereby exposing them to *pro rata* distributions and loss-sharing. Creation and maintenance of fully-segregated accounts necessarily will result in some additional costs that likely will be borne by customers. For that reason, we prefer that use of such accounts would be on a voluntary basis, at the agreement of an FCM and its customers.

We believe that a pilot program would be a useful way to test the mechanics of this new account structure and to begin to judge its true costs. The NGFA will look to work with commodity customers, FCMs, lenders and regulators to identify potential participants. We believe a pilot program leading to fully-segregated accounts can be implemented relatively quickly without the need for legislation.

Insurance for Commodity Futures Customer Accounts

Because a fully-segregated account structure may not prove to be a practical alternative for all customers, the NGFA also has recommended that insurance coverage be extended to commodity customers, in much the same way that insurance protection currently exists for securities customers under the Securities Investor Protection Corporation (SIPC). Details involving the appropriate level of coverage and funding will need to be determined, but we believe the added protection for customers will be perceived as significant and meaningful in today's environment.

Dodd-Frank Implementation

Finally, I would like to share with the Committee the NGFA's views on the ongoing implementation by CFTC of the Dodd-Frank law. We believed from the beginning that agriculture, and the use of agricultural risk management tools, had nothing to do with the financial crisis that served as the catalyst for passage of Dodd-Frank. Responding to the barrage of proposals from the CFTC to implement Dodd-Frank has required much time and effort by agriculture and agribusiness firms.

While some uncertainties still exist in how the law will be implemented by the CFTC, the NGFA generally has appreciated the Commission's openness and responsiveness to agriculture and agribusiness concerns. However, I would like to close my testimony with some comments about one proposal that has generated serious and widespread concern among NGFA-member firms and the agricultural producers with whom they work so closely.

Briefly, the proposal would require that any member of a designated contract market (DCM)—like the Chicago Board of Trade, Kansas City Board of Trade or Minneapolis Grain Exchange—record all oral communications that could lead to a cash transaction. In addition, records would need to be kept for CFTC inspection for up to 5 years, identifiable by counterparty and transaction. There are several problems with the proposal as currently written:

- The proposal would require, for example, a country elevator operated by a company that is a member of a commodity futures exchange to record telephone conversations with farmers about a forward cash contract—contracts that specifically are exempted in the Commodity Exchange Act from CFTC's jurisdiction. Taken even farther, a country elevator manager's conversation behind the stands at the high school football game on Friday night with a farmer in the community about buying cash grain the next day would be required to be recorded. Clearly, this would constitute a huge expansion of CFTC's authority in the cash marketplace.
- Country elevators are not equipped with the technology to record conversations and maintain a record of them. The proposal would require a huge new investment in communications technology for many small businesses.
- The proposal would create a bifurcated cash marketplace in which some grain purchasers would be required to record communications and maintain records, while others not operated by a member of a DCM would not be covered by the rule. Will a farmer call the elevator where all conversations must be recorded and records kept for CFTC inspection, or the elevator down the road where no such requirement exists? Serious competitive issues are involved.

The NGFA respectfully suggests that the enforcement goals of the Commission can be effectively accomplished and better served without this huge new intrusion into the cash grain marketplace.

Thank you for the opportunity to share the views of the National Grain and Feed Association. I would be happy to respond to any questions.

ATTACHMENT 1

April 2, 2012

Hon. GARY GENSLER,
Chairman,
Commodity Futures Trading Commission,
Washington, D.C.

Dear Chairman Gensler:

The demise of MF Global has shaken the confidence of many futures market participants with regard to the safety of segregated customer funds. Many NGFA-member companies continue to struggle to recover their funds and property.

The NGFA respectfully submits the following *preliminary* recommendations as first steps to begin re-establishing confidence among futures market participants and to help safeguard customer funds. However, it is extremely important that these types of changes—designed to enhance reporting, transparency and accountability, with recommendations we believe should be relatively easily implemented—are not the end of efforts to ensure that another MF Global-type situation never recurs.

The NGFA's MF Global Task Force continues its work to examine various *models for segregating and safeguarding customer funds;* to explore the *viability and costs of extending insurance coverage to commodities accounts;* and to analyze potential *changes to the U.S. Bankruptcy Code* to provide customers with needed protection, especially to protect customer segregated funds from being swept into liquidation proceedings and to ensure that "safe harbor" rules under the Bankruptcy Code aren't used to preclude retrieving customer funds. We expect to issue additional recommendations in these areas soon. In all these efforts, our bedrock principle will be:

"Customers Come First"

The preliminary recommendations of the NGFA are as follows:

- The CFTC should require daily reporting of segregated fund positions by FCMs to both their Self-Regulatory Organization (SRO) and to the CFTC.
- The CFTC should require daily reporting of segregated fund investments by FCMs, detailed by maturity and quality, to both their SRO and to the CFTC.
- The CFTC should conduct a formal review of FCM investment options for customer funds, with a view to whether the Commission should further limit allowable investments only to very safe instruments.
- The CFTC should require reporting by FCMs to their SRO and to the CFTC of significant changes in investment policies or holdings.
- FCMs should be required to provide greater transparency to customers of where customer funds are invested, potentially achieved through means such as posting on the CFTC website, FCM websites and/or publication in a customer "prospectus."
- The CFTC and SROs should enhance monitoring of FCM reporting. Both regulators should conduct more detailed and more frequent audits, and unannounced spot checks of FCMs.
- To assign accountability and to aid in establishing that fraudulent activity has occurred in the event customer funds are misappropriated, CFTC should require the signature of two authorized principals of an FCM (*e.g.,* CEO, CFO or other senior officers) to move funds out of segregated customer fund accounts to non-customer accounts.
- FCMs should be required to provide immediate notice to their SRO and to the CFTC if the firm moves more than some percentage, to be determined by the CFTC, of excess segregated funds to non-customer accounts.
- FCMs should be required by their SRO to periodically certify policies and procedures to ensure the safeguarding of customer segregated accounts and compliance with applicable laws and regulations regarding such accounts. As part of all examinations by SROs, principals of FCMs must certify that policies and procedures are adequate, effective and being observed by the FCM. At least annually, SROs should be required by CFTC to review policies and procedures to determine adequacy and compliance.
- A rigorous review by the CFTC of capital requirements for FCMs and broker-dealers needs to be conducted, with a view to scrutinizing the current practice of allowing double-counting of required capital when a firm operates as both an FCM and a broker-dealer.

We appreciate the opportunity to share these recommendations with you, and we look forward to working with you to ensure that customer funds truly are segregated and safe from future misappropriation.

Sincerely,

MATT BRUNS,
Chair,
Risk Management Committee;

JOHN HECK,
Chair,
Finance and Administration Committee.

ATTACHMENT 2

June 29, 2012

Hon. FRANK D. LUCAS,
Chairman,
House Committee on Agriculture,
Washington, D.C.;

Hon. COLLIN C. PETERSON,
Ranking Minority Member,
House Committee on Agriculture,
Washington, D.C.

Dear Chairman Lucas and Ranking Member Peterson:

As you are well aware, companies and individuals that were customers of MF Global Inc.'s futures business continue to deal with the aftermath of parent company MF Global Holdings' bankruptcy and the subsequent liquidation of the futures commission merchant (FCM). Most customers so far have received distributions from the trustee of about 72% of their funds—funds that were supposed to have been segregated and protected—with no assurance of being made whole.

Shortly following MF Global's demise, the National Grain and Feed Association (NGFA) established a task force to formulate recommendations for change to help ensure that another MF Global-type situation does not occur. On April 2, we submitted to Congress and to the Commodity Futures Trading Commission (CFTC) a number of preliminary recommendations for enhanced reporting, transparency and accountability (attached).* We are pleased that the CFTC and the regulated exchanges have begun to implement some changes quite similar to the NGFA's preliminary recommendations.

This letter transmits a second set of NGFA policy recommendations. Many of these changes will require action by Congress and/or the CFTC, and we urge expeditious consideration to protect customers' funds and to reinforce the principle that "Customers Come First."

The NGFA's recommendations are as follows:

Reforms to U.S. Bankruptcy Code—The NGFA believes strongly that reforms to the U.S. Bankruptcy Code are critically important to preserving customers' rights and protecting customers' assets in the event of future FCM insolvencies. To that end, the NGFA recommends the following statutory changes:

- 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. The NGFA recommends that Part 190 regulations of the CFTC should be incorporated into Subchapter IV of Chapter 7 of the Bankruptcy Code to harmonize the statutes and avoid interpretative inconsistencies.
- Under SIPA, the SIPC is authorized to select a trustee and to oversee the trustee's compensation, while the CFTC has a limited role. Further, the SIPA trustee is obligated to protect the interests of both securities and commodities customers. In order to strengthen commodity customer protection, the NGFA recommends that 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. (This recommendation is not intended as a criticism of the SIPA trustee appointed to oversee liquidation of MF Global Inc. However, in a case where over 95% of the assets and accounts affected were those of commodities customers, we believe the CFTC should play a much larger role.)
- Currently, an FCM is required to keep customer funds segregated from the firm's proprietary funds, but customer property is commingled. As a result, under the current statutory scheme, all customers share *pro rata* in the event of a shortfall. The NGFA recommends that 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. Knowing that their claims could be subordinated in the event of a shortfall would provide incentives to the FCM and any controlling parent firm to ensure adequate internal controls to prevent segregation violations. Further, this provision would provide clarity to regulators and to the courts in terms of prioritization of claims, an area in which precedent has not been established.
- 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. FCM for establishment of customer committees. The NGFA recommends that the Bankruptcy Code expressly should authorize the establishment of customer committees to represent customer interests.
- 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.

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 would welcome the opportunity to work cooperatively with such groups to develop consensus reforms that can be moved by Congress expeditiously.

* **Editor's note:** the document referred to is the preceding attached letter dated April 2, 2012.

Fully Segregated Customer Accounts—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). In the case of MF Global, the result has been that former customers of the firm so far have received only 72% of their supposedly safe segregated funds back through distributions from the trustee, with no assurance that they ever will receive all of their funds. We believe strongly that a new type of account structure needs to be established for use by FCM customers on a voluntary basis that will shield customer assets from pooled losses in the event of an FCM bankruptcy.

It will be of paramount importance in establishing this new structure that fully-segregated customer funds not fall under the "customer funds" definition of the Bankruptcy Code, thereby exposing them to *pro rata* distributions (as discussed above in recommendations for changes in the Bankruptcy Code.)

Creation of a fully-segregated account structure necessarily will result in some additional costs that likely will be borne by customers utilizing this voluntary option. If that is the case, it is likely that some customers will opt for the added protections despite extra costs, and some customers will 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. The NGFA will look to work with like-minded organizations to design a full-segregation option that responds to customer needs.

Pilot Program for Full-Segregation Option—We suggest that a pilot program involving commodity futures customers, FCMs, banks and regulators could be a useful means of testing the mechanics and beginning to judge the true costs of a full-segregation structure—and in the process, moving as quickly as possible toward a more generally available full-segregation option for customers. The NGFA recommends a pilot program at the earliest possible date, and commits here to working with its member firms, the CFTC and other parties to identify potential participants.

SIPC-Like Insurance for Commodity Futures Customer Accounts—Because the full-segregation option discussed above may not prove to be a practical alternative for all market participants, the NGFA recommends that insurance coverage in the event of an FCM bankruptcy be extended to commodity futures accounts similar to that currently provided for securities customers.

Much in the way that the Securities Investor Protection Corporation (SIPC) has provided insurance protection for securities accounts, the NGFA recommends creation of a similar structure for commodities. We believe that a significant fund could be established through very modest dedicated assessments on commodity futures transactions. Details concerning the appropriate size of such a fund and the appropriate level of assessment will need to be determined, but we believe the customer protections provided will be significant and meaningful to market participants.

The NGFA does not recommend herein whether housing a commodity futures insurance fund within the existing structure of the SIPC is the correct solution, or whether a new and separate entity resembling the SIPC but dedicated to providing insurance protection for commodity futures accounts should be established. However, we believe strongly that insurance protection for commodity futures accounts should be established, action that likely will require authorizing legislation. We look forward to working with Congress to achieve that goal.

We look forward to working with Congress, the CFTC and other stakeholders to achieve the afore-mentioned changes with the goal of protecting customer funds, both prior to and following a bankruptcy or an FCM insolvency. Please do not hesitate to contact the NGFA with any questions.

Sincerely,

MATT BRUNS,
Chair,
Risk Management Committee;

JOHN HECK,
Chair,
Finance and Administration Committee.

The CHAIRMAN [presiding.] Thank you, sir.

Mr. Conner, you are recognized for 5 minutes.

STATEMENT OF HON. CHARLES F. CONNER, PRESIDENT AND CHIEF EXECUTIVE OFFICER, NATIONAL COUNCIL OF FARMER COOPERATIVES, WASHINGTON, D.C.

Mr. CONNER. Chairman Lucas, Congressman Boswell, and Members of the Committee, on behalf of the nearly 3,000 farmer-owned cooperatives and their producer-members, thank you for the opportunity to testify today to discuss implementation of the Dodd-Frank Act.

The over-the-counter markets have given cooperatives and their producer members important tools to manage their exposure and hedge their risk during the volatile commodity markets that we have seen over the last few years. This Committee's oversight of CFTC as they have written the rules regulating the over-the-counter markets has been instrumental in ensuring that co-ops and farmers continue to have access to those innovative risk-management tools. I would simply like to personally thank you for your work and your staff's work in this area.

This continued oversight is important as the process now turns from one of rulemaking to one of compliance. This shift is something that NCFC members are now grappling with. They must clearly understand the provisions of the regulations while also figuring out how different regulations will fit together into a coherent regulatory framework. Our members are finding it very challenging to understand exactly what needs to be done in order to be in compliance at the end of the day, and of course, they want to be in compliance.

Part of the concern also lies with CFTC's eventual enforcement of new regulations. As we have throughout the process, we do urge the CFTC to continue to work closely with industry and take a collaborative approach to compliance. We hope the CFTC will lend a hand and help and educate us, not as a regulator looking to make an example out of honest mistakes, misunderstandings and oversights but rather as a partner determined to see us meet these requirements.

This would be a continuation, Mr. Chairman, of the willingness that CFTC has shown to listen to our concerns throughout this rulemaking process. As an example, much of the regulatory uncertainty for farmer co-ops has recently been resolved. Most significant is the definition of *swap dealer*. The Commission under Chairman Gensler's leadership took the time to understand farmer co-ops and made a significant improvement in the final rule. As such, farmer co-ops will not be regulated as swap dealers.

Other rules that have not yet been finished continue to cause uncertainty over the new costs that will be imposed on farmers and their co-ops. Incremental increases in cost, whether passed on from a swap dealer or imposed directly on the cooperative, of course will trickle down and impact our producer-owners. For example, one CFTC proposal imposes additional record-keeping requirements in the cash commodity markets has been noted. We appreciate Chairman Gensler's earlier comments stating that he has no intention of imposing this new requirement, and we would encourage the Committee to follow up on this commitment.

Other regulatory burdens could also impact our members' hedging activities. For instance, swap dealers who co-ops often use to lay off the risk of offering forward contracts must comply with capital and margin requirements, which has not yet been finalized by the agency. How these costs will be passed on to end-users remains to be seen and again could dramatically impact the cost-effectiveness of commercial hedging via the over-the-counter market.

Finally, Mr. Chairman, there is still a question of whether the so-called Prudential Regulators will require bank swap dealers to collect margin from end-users. We appreciate very much this Committee's work on this issue, and of course the House passage of the Business Risk Mitigation and Price Stabilization Act by an overwhelming vote. Clearly, mandatory margin would increase the cost again of hedging operations and ultimately discourage this very prudent business practice.

Thank you again for the opportunity to testify today, Mr. Chairman, and I look forward to any questions you may have.

[The prepared statement of Mr. Conner follows:]

PREPARED STATEMENT OF HON. CHARLES F. CONNER, PRESIDENT AND CHIEF EXECUTIVE OFFICER, NATIONAL COUNCIL OF FARMER COOPERATIVES, WASHINGTON, D.C.

Chairman Lucas, Ranking Member Peterson, and Members of the Committee, thank you for the invitation to testify today on the implementation of the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act).

I am Chuck Conner, President and Chief Executive Officer of the National Council of Farmer Cooperatives (NCFC). NCFC represents the nearly 3,000 farmer-owned cooperatives across the country whose members include a majority of our nation's more than two million farmers.

Farmer cooperatives—businesses owned, governed and controlled by farmers and ranchers—are an important part of the success of American agriculture. They are a proven tool to help individual family farmers and ranchers through the ups and downs of weather, commodity markets, and technological change. Through their cooperatives, producers are able to improve their income from the marketplace, manage risk, and strengthen their bargaining power, allowing individual producers to compete globally in a way that would be impossible to replicate as individual producers.

In particular, by providing price risk management tools to their farmer-owners, farmer cooperatives help mitigate commercial risk in the production, processing and selling of a broad range of agricultural and food products. America's farmers and ranchers must continue to have access to new and innovative risk management products that enable them to feed, clothe and provide fuel to consumers here at home and around the world. The ongoing drought across much of the country, which is impacting so many producers so severely, once again illustrates the need for a multilayered risk management strategy in agriculture.

We greatly appreciate the ongoing oversight this Committee has provided as the Dodd-Frank rules have been written. Your work in encouraging the Commodity Futures Trading Commission (CFTC) to ensure that the agriculture industry has affordable access to innovative risk management tools once the Act is implemented is commendable. With your continued leadership, agriculture will hopefully avoid being subject to a one size fits all type of regulation intended for Wall Street.

Cooperatives' Use of the OTC Market

As processors and handlers of commodities and suppliers of farm inputs, farmer cooperatives are commercial end-users of the futures exchanges as well as the over-the-counter (OTC) derivatives markets. Due to market volatility in recent years, cooperatives are increasingly using OTC products to better manage their exposure by customizing their hedges. This practice increases the effectiveness of risk mitigation and reduces costs to the cooperatives and their farmer-owners. Swaps also play a critical role in the ability of cooperatives to provide forward contracts, especially in times of volatile markets. Because commodity swaps are not currently subject to the same margin requirements as the exchanges, cooperatives can use them to free up working capital.

OTC derivatives are not just used for risk management at the cooperative level, however. They also give the cooperative the ability to provide customized products to farmers and ranchers to help them better manage their risk and returns. Much like a supply cooperative leverages the purchasing power of many individual producers, or a marketing cooperative pools the production volume of hundreds or thousands of growers, a cooperative can aggregate its owner-members' small volume hedges or forward contracts. It can then offset that risk by entering into another customized hedge via the swap markets.

Implementation of the Dodd-Frank Act

NCFC supports elements of the Dodd-Frank Act that bring more transparency and oversight to the OTC derivatives markets. We also recognize the complexity in crafting rules for the implementation of Dodd-Frank that best fit cooperatives and have had a number of opportunities to express our concerns to the CFTC. With the sheer volume of rules, the challenges in clearly understanding what is contained in those regulations, and the complexity of how they will fit together, NCFC members are now turning their attention to compliance. Our members are doing their best to put into place policies and procedures, but they are finding it a challenge to understand what exactly needs to be done to address the complex regulations.

Our members also have concerns regarding how CFTC will enforce the regulations. Because the regulations will be very complex, we urge CFTC to work closely with industry to ensure clear understanding by all parties.

During the rule writing process, we have worked to ensure that the implementation of the Dodd-Frank Act preserves risk management tools for farmers and their cooperatives, and have advocated for the following:

- Treating agricultural cooperatives as end-users because they aggregate the commercial risk of individual farmer-members and are currently treated as such by the CFTC;
- Excluding agricultural cooperatives from the definition of a swap dealer;
- Exempting agricultural cooperatives from mandatory clearing or margining but allowing them to perform either at their discretion; and
- Considering aggregate costs associated with the new regulations and the impact on the agriculture sector.

I am pleased to report that with the recent rulemakings, some of the uncertainty that created concern for farmer cooperatives over the past 2 years has been resolved. Most significant is the defining of "Swap Dealer." CFTC provided a definition in the final "entities" rule that will allow farmer cooperatives to provide risk management services to their members and customers without the fear of having to comply with the additional regulatory requirements intended for systemically important institutions. We appreciate the work of the Commission in addressing our concerns, which resulted in significant improvements in the final rule.

While we now know farmer cooperatives will not be treated as swap dealers, there are still many unknowns as to how implementation of the rules will affect cooperatives and their farmer members. Uncertainty over ultimate costs remains an ongoing a concern. As you know, agriculture is a high-volume, low-margin industry. Incremental increases in costs, whether passed on from a swap dealer or imposed directly on a cooperative, will trickle down and impact producers. Taken one rule at a time, the costs may not seem unreasonable, but to those who have to absorb or pass on the collective costs of numerous regulations, it is clearly evident those costs are significant.

For example, one "small" change in the proposed conforming amendments rule has to do with additional recording requirements. We are concerned this proposal would not only add swaps to the new record-keeping requirements, but also extend the new requirements to cash purchase and forward cash contracts entered into by any member of a designated contract market. One NCFC member estimates that installation of record-keeping systems in all of their facilities would cost over $6 million. In fact, the necessary investment to put in place and maintain such a system would not only greatly add to the cost of doing business, but would be an extreme compliance burden for the cash grain community (attached are the comments NCFC submitted to CFTC on this issue). We are hopeful CFTC will reconsider this requirement as it finalizes the rule in the coming months.

It is also unclear how other costs will be forced down to end-users and impact their ability to hedge. For example, recent movements in grain and oilseed markets have caused a considerable amount of working capital to be used to cover daily margin calls. The drought affecting the U.S. has caused corn prices to increase over 50 percent in the last month. While this creates an opportunity for farmers to price more of their crop, (if they haven't been impacted by the drought), it also causes additional margin calls on the production that has been priced. For farmers to continue to take advantage of selling grain forward during price rallies, cooperatives have to either increase borrowing or look for alternative ways to manage such risk, such as the OTC market. As was the case during the volatile markets in 2008, swaps allow cooperatives to free up working capital and continue to forward contract with farmers.

As commercial end-users, cooperatives often use swap dealers in utilizing the OTC market to lay off the risk of offering those forward contracts. However, the costs associated with dealers' compliance with capital, margin and other regulatory requirements are still unclear. We will have to wait to see how those costs are passed on to end-users and how cost effective the OTC market remains for hedging activities.

Consistent with Congressional intent, NCFC supports the CFTC's proposed rules clarifying that it "would not impose margin requirements on non-financial entities," and that "parties would be free to set initial and variation margin requirements in their discretion and any thresholds agreed upon by the parties would be permitted."

However, we are concerned the so-called "Prudential Regulators" margin proposal requires bank swap dealers to collect margin from end-users. As end-users, cooperatives use swaps to hedge interest rates, foreign exchange, and energy in addition to agricultural commodities. Often, cooperatives look to their lenders to provide those swaps. Under the proposed rule requiring end-users to post margin, costs to businesses will increase as more cash is tied up to maintain those hedges. The additional capital requirements will be siphoned away from activities and investment in cooperatives' primary business ventures. Furthermore, cash for margin is often borrowed from lenders through the use of credit lines. As a result, we could see a situation where a commercial end-user would have to borrow cash from its lender, and pay interest on it, just to give it back to the same lender to hold as margin. Congressional intent was clear on this point—end-users were not to be required to post margin. We appreciate the House of Representatives reaffirming this by passing the Business Risk Mitigation and Price Stabilization Act back in March.

Thank you again for the opportunity to testify today before the Committee. We appreciate your role in ensuring that farmer cooperatives will continue to be able to effectively hedge commercial risk and support the viability of their members' farms and cooperatively owned facilities. I look forward to answering any questions you may have.

ATTACHMENT

August 8, 2011

DAVID A. STAWICK,
Secretary,
Commodity Futures Trading Commission,
Washington, D.C.

RE: Adaptation of Regulations to Incorporate Swaps; Notice of Proposed Rulemaking (*Federal Register*/Vol. 76, No. 109)

Dear Mr. Stawick:

On behalf of the more than two million farmers and ranchers who belong to farmer cooperatives, the National Council of Farmer Cooperatives (NCFC) submits the following comments in response to the Commodity Futures Trading Commission's (the Commission) request for comments: *Adaptation of Regulations to Incorporate Swaps; Notice of Proposed Rulemaking,* to amend the Commodity Exchange Act regulations to implement regulatory requirements contained in Title VII of the Dodd-Frank Wall Street Reform and Consumer Protection Act.

Since 1929, NCFC has been the voice of America's farmer cooperatives. Our members are regional and national farmer cooperatives, which are in turn composed of over 2,500 local farmer cooperatives across the country. NCFC members also include 21 state and regional councils of cooperatives.

America's farmer-owned cooperatives provide a comprehensive array of services for their members. These diverse organizations handle, process and market virtually every type of agricultural commodity produced. They also provide farmers with access to infrastructure necessary to manufacture, distribute and sell a variety of farm inputs. For example, a cooperative may consist of a closely coordinated network to ensure timely and cost-efficient origination, storage, transportation and marketing of grain and oilseeds.

Proposed Changes to Regulation 1.35

NCFC is concerned with this proposal because it would not only add swaps to the new record-keeping requirements, but also would extend the new record-keeping requirements to cash purchase and forward cash contracts entered into by any member of a designated contract market (DCM).

This would require all farmer cooperatives that are members of DCMs (CME, KCBT, MGE, *etc.*), and by extension every one of their local facilities, to be bound by this regulation. For example, cooperatives that are members of DCMs have an integrated network of grain elevators to originate and store grain purchased from farmers. As such, the proposed change to 1.35(a) would require those elevators to record, among other things, all oral communications that lead to execution of cash transactions with farmers. The proposal includes (*proposed additions in italics*):

> Included among such records shall be all orders (filled, unfilled, or canceled), trading cards, signature cards, street books, journals, ledgers, canceled checks, copies of confirmations, copies of statements of purchase and sale, and all other records, which have been prepared in the course of its business of dealing in commodity interests and cash commodities, *and all oral and written communications provided or received concerning quotes, solicitations, bids, offers, instructions, trading, and prices, that lead to the execution of transactions in a commodity interest or cash commodity, whether communicated by telephone, voicemail, facsimile, instant messaging, chat rooms, electronic mail, mobile device or other digital or electronic media. Each transaction record shall be maintained as a separate electronic file identifiable by transaction and counterparty.*

Additionally, all such recorded communications would be required to be maintained for 5 years.

A requirement to record all communication leading to a cash purchase or cash forward contract would impose huge regulatory burdens and costs on cooperatives and other businesses and farmers in rural America. In fact, the necessary investment to put in place and maintain such a system would not only greatly add to the cost of doing business, but would be an extreme compliance burden for the cash grain community.

The Commission states these record-keeping requirements would protect customers from abusive sales practices; protect registrants from risks associated with transactional disputes; allow registrants to follow up more effectively on customer complaints; and preserve evidence that could increase the effectiveness of the Commission's enforcement actions. We do not believe that requiring this additional information to be recorded and maintained is necessary to achieve the stated goals in the cash commodity markets.

Additionally, we do not believe the intent of the Dodd-Frank Act was to subject cash purchases and forward cash contracts to the additional new record-keeping requirements proposed under regulation 1.35. In fact, cash and forward contracts have been excluded from the definition of a swap in the proposed product definitions rule. Commission Chairman Gary Gensler has highlighted that point on several occasions while testifying before Congress. We believe this proposed regulation, as written to apply to the cash market, is in direct contradiction to that exclusion and to the Congressional intent of the Dodd-Frank Act.

We would be pleased to discuss with the Commission our concerns with proposed regulation 1.35. Thank you taking our views into account as the Commission finalizes rules in the coming months. We appreciate the opportunity to provide input throughout the process of implementation of Title VII of the Dodd-Frank Act.

Sincerely,

CHARLES F. CONNER,
President & CEO.

The CHAIRMAN. Thank you.

Mr. McElroy, you are recognized for 5 minutes. You may proceed whenever you are ready.

STATEMENT OF PAUL E. MCELROY, CHIEF FINANCIAL OFFICER, JEA, JACKSONVILLE, FL; ON BEHALF OF AMERICAN PUBLIC POWER ASSOCIATION

Mr. MCELROY. Chairman Lucas, Ranking Member Boswell, and Committee Members, thank you for the opportunity to testify this morning. I am Paul McElroy, Chief Financial Officer for JEA. JEA proudly serves more than 400,000 electric customers in and around

Jacksonville, Florida. Our business is ensuring that our customers' electric demands are met reliably and economically today and for generations to come.

I am testifying on behalf of the American Public Power Association, APPA, the national service organization representing over 2,000 government-owned electric utilities providing power to more than 46 million people. Additionally, my comments are supportive of the positions of the Large Public Power Council, which represents the 26 largest municipal entities in the country.

Today I will discuss the swap-dealer rule under the Dodd-Frank Act. APPA supports Dodd-Frank and continues to work with the CFTC and others to improve its implementation. Chairman Gensler mentioned our involvement earlier today. However, we remain concerned that the CFTC's swap-dealer rule, which took effect Monday, will hinder our members' ability to hedge commercial price and operational risks.

We have a long and successful history of hedging commercial risk for the benefit of our customers, often utilizing swaps of physical commodities such as natural gas, electric capacity and energy, and coal, all of which are needed for our commercial operations. This is not different than swap activity used in the operations-related hedging activity of any other electric utility. At issue are the *de minimis* thresholds set by the CFTC to determine whether a swap participant is a swap dealer. Under the rule, a swap participant will be considered a swap dealer if it engages in more than $3 billion in swap dealing but just $25 million if dealing with special entities. Special entities are governmental entities including government-owned utilities such as APPA's members. The CFTC says it imposed the $25 million threshold in light of the protections that Dodd-Frank provides for special entities. However, Dodd-Frank never mentions forcing a non-financial participant into the swap-dealer regime for entering into swaps with a special entity.

Our concern is that non-financial entities on whom we rely for hedging such as natural gas producers, independent generators and investor-owned utility companies will stop dealing with us to avoid the $25 million threshold because but for those dealings with us, they would not be pulled into the Dodd-Frank swap-dealer regime. We are also concerned that large financial firms, ones which will be considered swap dealers in any case, will not fill this gap. Electric power is regionally diverse in both supply and demand. Because of this diversity, there are often limited counterparties for operations-related swaps. Large financial institutions may neither have the ability nor the desire to provide such highly customized, localized transactions.

The loss of non-financial swap partners will put us at a disadvantage to other utilities in our ability to effectively manage power supply costs and operations for our customers. Each swap counterparty in the market brings important market liquidity and diversity. If non-financial parties refuse to enter into swaps with us, price competition will be reduced, operational risk will increase, and our ratepayers will be hurt. This will affect all APPA members and so APPA and other government-owned utility groups have petitioned the CFTC to amend the swap-dealer rule.

Our proposed amendment would not, and I will repeat, would not remove the overall swap-dealer threshold nor the sub-threshold. It simply asks that our operations-related swaps not count toward the special-entities sub-threshold. Local- and state-owned utilities have experience and expertise to understand the operations-related swaps transactions they use to manage their commercial risk and do not need the special protections intended by the $25 million sub-threshold. In fact, and ironically, these protections will likely expose us and our customers to greater risk.

Thank you for this opportunity again to testify.

[The prepared statement of Mr. McElroy follows:]

PREPARED STATEMENT OF PAUL E. MCELROY, CHIEF FINANCIAL OFFICER, JEA, JACKSONVILLE, FL; ON BEHALF OF AMERICAN PUBLIC POWER ASSOCIATION

Mr. Chairman and Members of the Committee, I am Paul McElroy, Chief Financial Officer for JEA testifying today on behalf of the American Public Power Association (APPA). APPA is the national service organization representing the interests of over 2,000 municipal and other state- and locally-owned, not-for-profit electric utilities throughout the United States (all but Hawaii). Collectively, public power utilities deliver electricity to one of every seven electricity customers in the United States (approximately 46 million people), serving some of the nation's largest cities. However, the vast majority of APPA's members serve communities with populations of 10,000 people or less.

JEA is a member of APPA. We are located in Jacksonville, Florida, and proudly serve an estimated 420,000 electric, 305,000 water, and 230,000 sewer customers in Northeast Florida. JEA was created by the City of Jacksonville to serve those who live there and in the surrounding communities. The sole purpose of our business is to ensure that the electric, water and sewer demands of our customers are met, both today and for generations to come. Our goal is to provide reliable services at a good value to our customers while ensuring that our areas' precious natural resources are protected.

Public Power Utilities and Implementation of the Dodd-Frank Act

APPA supports the goals of the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act) and has worked closely with the Commodity Futures Trading Commission (CFTC) and other interested parties hoping to improve its implementation, particularly related to regulations affecting "end-users" of energy such as JEA and other APPA members. Even today, now 2 years after enactment, the full effect of the Dodd-Frank Act on public power utilities is unclear as regulations implementing the statute continue to be promulgated. We strongly support the CFTC's efforts to issue these regulations in a timely fashion while also accommodating a necessary discussion among stakeholders to fully vet these rules for unintended or adverse consequences.

One such instance is the final swap-dealer rule,[1] which took effect on July 23, 2012. As written, the rule will substantially hinder public power and public gas utilities' ability to hedge against operational risks. Just like JEA, these utilities have no shareholders, so the costs imposed by this regulatory decision will be borne by only one group: our ratepayers.

As you know, the Dodd-Frank Act requires swap dealers and major swap participants to register with the CFTC and meet capital, margin, and reporting and record-keeping requirements, as well as to comply with rigorous business conduct and documentation standards. The Dodd-Frank Act provides additional standards for swap dealers or major swap participants advising or entering into swaps with government-owned utilities and other government entities (referred to under the statute as "special entities"). For swap dealers advising or seeking to advise a special entity, the law states that it is "unlawful" to defraud that special entity.[2] For swap dealers or major swap participants entering into swaps with special entities, the law states that these dealers and swap participants must comply with rules set

[1] CFTC Regulation 1.3(ggg)(4); see 77 *Fed. Reg.* 30596, at 30744.
[2] 7 USCA § 6s(h)(4).

by the CFTC requiring special entities to have an independent representative before trading with a swap dealer or major swap participant.[3]

In December 2010, the CFTC (jointly with the Securities and Exchange Commission) issued a proposed rule to define the term "swap dealer," including (as required by the Dodd-Frank Act)[4] an exemption from the swap-dealer designation for those entities that engage in a *de minimis* quantity of swap dealing.

In the proposed rule, CFTC proposed two separate *de minimis* thresholds relating to the dollar quantity of swaps: $100 million annually for an entity's total swap-dealing activity; and, $25 million annually for an entity's swap-dealing activity with special entities, including, as noted above, public power, public gas, and Federal utilities (government-owned utilities).

In February, 2011, the Not-For-Profit Electric End User Group (NFP EEU)—which includes APPA-filed comments on the proposed swap dealer rule. The comments recommended that the CFTC substantially increase the *de minimis* thresholds both for total swaps and for swaps with special entities.

A final rule was approved by the CFTC on April 18, 2012, and was published in the *Federal Register* on May 23, 2012. The final rule greatly increased the overall *de minimis* threshold from the proposed rule, raising it from $100 million to $3 billion. During an initial phase-in period, this threshold will be $8 billion. But, the final rule did not change the proposed rule's $25 million sub threshold for swap-dealing activities with special entities. Thus, the disparity between the two thresholds is now substantially greater. This $25 million sub-threshold is smaller still when you consider that it is the aggregate of a swap partner's transactions with **all** special entities during any 12 month period.[5]

As a result, non-financial entities (such as natural gas producers, independent generators, and investor-owned utility companies) that do not want to be swap dealers will severely limit their swap-dealing activities with government-owned utilities to avoid exceeding the $25 million threshold.

Why Hedging Is Necessary

Government-owned utilities depend on nonfinancial commodity transactions, trade options and "swaps," as well as the futures markets, to hedge commercial risks that arise from their utility facilities, operations and public service obligations. Together, nonfinancial commodity markets play a central role in the ability of government-owned utilities to secure electric energy, fuel for generation, and natural gas supplies for delivery to consumers at reasonable and stable prices. Specifically, many government-owned utilities purchase firm electric energy, fuel and gas supplies in the physical delivery markets (in the "cash" or "spot" or "forward" markets) at prevailing and fluctuating market prices, and enter into bilateral, financially-settled nonfinancial commodity swaps with customized terms to hedge the unique operational risks to which many government-owned utilities are subject.

In hedging, mitigating or managing the commercial risks of their utility facilities' operations or public service obligations, government-owned utilities are engaged in commercial risk management activities that are no different from the operations-related hedging of an investor-owned utility or an electric cooperative located in the same geographic region.

Why Nonfinancial Counterparties Are Necessary

Electric power touches virtually every home and business in the United States. This near universality gives a false appearance of homogeneity. It is important to remember that what is being delivered is a physical commodity, *e.g.,* electricity, coal, or natural gas. Ownership of a stock can be transferred coast to coast with a click of a button, but electricity must be delivered to the place it is to be used.

Each regional geographic market has a somewhat different set of demands driven by climate, weather, population, and the like. Each regional geographic market also has a somewhat different group of financial entity counterparties and nonfinancial entity counterparties available to meet these demands and thus able to enter into customized utility operations-related swaps needed for hedging price and supply risks. For example, a large merchant electric generation station in western Alabama might be available as a nonfinancial counterparty for a swap transaction to provide electricity to a specific site in Alabama. But that same entity would not necessarily

[3] 7 USCA § 6s(h)(5).

[4] 7 USCA § 1a(49)(D).

[5] By way of reference a single, 1 year 100 MW swap could have a roughly $25 million notional value. One-hundred MWs of power is enough to serve the average demand of approximately 75,000 residential customers.

be able to offer the electricity in Oregon, and so would not be able to help an Oregon-based utility hedge its risks.

Because there are a limited number of counterparties for any particular operations-related swap sought by a utility, each financial or nonfinancial swap counterparty brings important market liquidity and diversity. The greater the number of counterparties, the greater the price competition. Conversely, reduced price competition necessarily increases prices.

JEA and the Special Entity Sub Threshold

I would like to illustrate these points with examples from my JEA's perspective.

As discussed above, the primary mission of JEA's electric system is to provide reliable and low cost electricity to our customers. I will say that again. While ensuring sufficient supply to serve our customers is primary, running a very close second is managing commodity fuel and purchased power costs. We accomplish this by efficiently and cost-effectively managing supply and price risks inherent in the procurement of fuel and power.

Take, for example, a capacity and energy swap between JEA and another municipal utility. This swap is intended to diversify our electric generation capability. By way of background, JEA has a large commitment solid fuel, while our swap partner in this example has a significant commitment to natural gas. And, history has taught us the importance of diversification time and time again.

This swap would be governed by Dodd-Frank: it would qualify for the end-user exception so would not have to be cleared, but one of the parties would have to report the transaction. However, the notional amount of the swap would exceed $25 million, and, if it were considered "dealing" activity under the rules' facts and circumstances guidelines, would invoke the sub-threshold provision.

This leaves us with the options of (1) having one party register as a dealer, (2) placing a registered dealer between the parties, or (3) affecting a physical exchange instead of a swap.[6] All of these solutions add complexity and cost, do nothing to reduce systemic financial risk, and will cause the transaction to be abandoned. That said, the same transaction, were it **not** to involve special entities, would impose none of the added cost and complexity. This seems neither appropriate, nor fair.

Likewise, JEA seeks to maximize flexibility regarding terms and conditions governing supply and price in all long-term fuel and purchased power contracts. This gives us the flexibility to efficiently and cost-effectively manage supply and price risks in fuel and power procurement. However, we have been told by several nonfinancial energy suppliers who currently serve as swap partners, none of whom are currently dealers, that they are looking closely at the "special entity sub-threshold" to determine the terms and conditions they may be willing to extend to us in the future.

When a major fuel supplier says they are "reevaluating" contractual terms and conditions, it almost certainly means that the level of flexibility we currently enjoy will be curtailed or eliminated and our costs and risk profile will increase. Again, however, this supplier can continue to extend to utilities that are not special entities contracts under the existing terms. And again, this seems neither appropriate, nor fair.

These are just two examples of how the sub threshold will affect JEA. As noted above there is a great deal of heterogeneity among APPA members, including in the use of hedging. Some make substantial use of hedging: others do not. Likewise, of APPA members who do make use of hedging, a recent informal survey of members showed great diversity in terms of the volume of hedging and the extent to which members relied on non-financial entities.

However, the rules could still affect all of our members. Members currently hedging will be affected, but so will smaller members who buy power from larger members who do. For example, while a small municipal electric distribution utility[7] in Oklahoma might not hedge its risks, it may buy its power from a larger public power provider—such as the Oklahoma Municipal Power Authority—which does. Also, those who do not currently hedge will be restricted in their ability to do so in the future.

The CFTC has said that it retained the $25 million threshold in light of the special protections that the Dodd-Frank Act affords to special entities. However, the statute does not require—even mention—special protections for special entities in regard to the swap dealer definition. As noted above, the law imposes requirements

[6] A physical exchange would be structured as two separate purchase power agreements, incorporating the costs of transmission and ancillary services.

[7] An electric distribution utility is one which solely distributes electricity, as distinguished from one which generates and distributes electricity.

on swap dealers and major participants advising or entering into swaps with special entities. Nowhere does the law mention deeming a participant to be a swap dealer solely because they happen to be entering into swaps with a government-owned utility.

APPA thinks the distinction in the law is appropriate. Government-owned utilities understand the operations-related swap transactions they use to manage their commercial risks and do not need the special protections provided by the $25 million sub-threshold. **In fact, and ironically, these "protections" are likely to limit the ability of these utilities to hedge operational and price risks rather than to protect these utilities and their customers from risk.**

Government-Owned Utilities' Petition for Rulemaking

On July 12, 2012, APPA, the Large Public Power Council (LPPC), the American Public Gas Association (APGA), the Transmission Access Policy Study Group (TAPS), and the Bonneville Power Administration (BPA), filed with the CFTC a "Petition for Rulemaking to Amend CFTC Regulation 1.3(ggg)(4)." The petition (see the attachment to this testimony) requests that the CFTC amend its swap-dealer rule to exclude utility special entities' operations-related swap transactions from counting towards the special-entity threshold. This amendment to the swap-dealer rule would allow producers, utility companies, and other non-financial entities to enter into energy swaps with government-owned utilities without danger of being required to register as a "swap dealer" solely because of their dealings with government-owned utilities.

Specifically, the petition asks for a narrow exclusion:

- A government-owned utility's swaps related to utility operations would not count towards the special entity *de minimis* threshold, but would count towards the total *de minimis* threshold.
- Utility operations-related swaps are those entered into to hedge commercial risks intrinsically related to the utility's electric or natural gas facilities or operations or to the utility's supply of natural gas or electricity to other special entities. For example, these would include swap transactions related to the generation, production, purchase or sale, or the transportation of electric energy or natural gas, or related to fuel supply of electric generating facilities.
- Utility operations-related swaps do not include interest rate swaps. Those swaps would remain subject to the $25 million special entity sub-threshold.

We urge Committee Members to support this petition.

Conclusion

In conclusion, the protections the CFTC is trying to afford through the $25 million special entity sub-threshold were not contemplated by the Dodd-Frank Act and are not needed for government-owned utility swaps related to utility operations. Government-owned utilities are well-versed in the markets in which they are hedging their risks and rely on these swaps solely to manage price and operational risks. More importantly, the assumption that financial firms will be able to replace all the swaps offered currently by our nonfinancial swap partners reflects a dangerous misunderstanding of how electricity is delivered and an indifference to the price Wall Street will impose in the absence of adequate competition and to the risk to supply if that price cannot be afforded. In sum, a failure to allow the narrow exclusion sought in our petition will limit our members' ability to hedge against risks and lead to increased risk and costs to the millions of ratepayers they serve.

Thank you again for this opportunity to testify, and I would be more than happy to answer any questions you might have.

ATTACHMENT

July 12, 2012

DAVID STAWICK,
Office of the Secretariat,
Commodity Futures Trading Commission,
Washington, D.C.

Re: Petition for Rulemaking to Amend CFTC Regulation 1.3(ggg)(4)

Dear Mr. Stawick:

The American Public Power Association ("APPA"), the Large Public Power Council ("LPPC"), the American Public Gas Association ("APGA"), the Transmission Access Policy Study Group ("TAPS") and the Bonneville Power Administration ("BPA") (collectively, the "Petitioners") respectfully petition the Commodity Futures Trading Commission (the "Commission" or the "CFTC") under CFTC Regulation 13.2 to amend CFTC Regulation 1.3(ggg)(4),[8] which implements the *de minimis* exception to the definition of "swap dealer." The Petitioners specifically request that the rule amendment exclude from the "special entity sub-threshold," which appears in Regulation 1.3(ggg)(4)(i), "Utility Operations-Related Swaps" to which the Petitioners and other "Utility Special Entities" are, or may in the future be, counterparties. The definitions of "Utility Operations-Related Swap" and "Utility Special Entity" are included directly in the text of the proposed rule amendment, and narrowly circumscribe the scope of the proposed rule amendment.

Such a rule amendment is permitted by Section 1a(49)(D) of the Commodity Exchange Act ("CEA") as amended by the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (the "Dodd-Frank Act"),[9] and is specifically contemplated by CFTC Regulation 1.3(ggg)(4)(v).[10] The rule amendment is necessary in order to preserve uninterrupted and cost-effective access to the customized, non-financial commodity swaps that Petitioners and other Utility Special Entities use to hedge or mitigate commercial risks arising from their utility facilities, operations and public service obligations.

The information required by CFTC Regulation 13.2 follows:

I. The Text Of The Proposed Rule Amendment (Additional language is underlined and italicized)

PART 1—GENERAL REGULATIONS UNDER THE COMMODITY EXCHANGE ACT

* * * * * * *

Section 1.3 Definitions.

* * * * * * *

(ggg) SWAP DEALER.

* * * * * * *

(4) *DE MINIMIS* EXCEPTION. (i) Except as provided in paragraph (ggg)(4)(vi) of this section, a person that is not currently registered as a swap dealer shall be deemed not to be a swap dealer as a result of its swap dealing activity involving counterparties, so long as the swap positions connected with those dealing activities into which the person—or any other entity controlling, controlled by or under common control with the person—enters over the course of the immediately preceding 12 months (or following the effective date of final rules implementing Section 1a(47) of the Act, 7 U.S.C. 1a(47), if that period is less than 12 months) have an aggregate gross notional amount of no more than $3 billion, subject to a phase in level of an aggregate gross notional amount of no more than $8 billion applied in accordance with paragraph (ggg)(4)(ii) of this section, and an aggregate gross notional amount of no more than $25 million *(the ''special entity sub-threshold''* with regard to swaps in which the counterparty is a "special entity" (as that term is defined in Section 4s(h)(2)(C) of the Act, 7 U.S.C. 6s(h)(2)(C), and § 23.401(c) of this chapter)*; provided that such $25 million special entity sub-threshold shall* **not** *apply with regard to ''utility operations related swaps'' to which the counterparty is a ''utility special entity.'' For purposes of this paragraph, (A) a ''utility special entity'' means a government ''special entity'' (as described in clause (i) or (ii) of Section 4s(h)(2)(C) of the Act or in clause (1) or (2) of § 23.401(c) of this chapter) that owns or operates electric or natural gas facilities or electric or natural gas operations (or anticipated facilities or operations), supplies natural gas and/or electric energy to other utility special entities, has public service obligations (or anticipated public service obligations) under Federal, state or local law or regulation to deliver electric energy and/or natural gas service to utility customers, or is a Federal power marketing agency as defined in Section 3 of the Federal Power Act (16 U.S.C. 796(19)), and (B) a ''utility operations-related swap'' shall mean any swap that a utility special entity enters into ''to hedge or mitigate commercial risks'' (as such phrase is used in Section 2(h)(7)(A)(ii) of the Act) intrinsically related to the electric or natural gas facilities that the utility special entity owns or operates or its electric or natural gas operations (or anticipated facilities or operations), or to the utility special entity's supply of natural gas and/or electric*

[8] 77 *Fed. Reg.* 30596, at 30744.
[9] Pub. L. No. 111–203, 124 Stat. 1376 (2010).
[10] 77 *Fed. Reg.* 30744–30745.

energy to other utility special entities or to its public service obligations (or anticipated public service obligations) to deliver electric energy or natural gas service to utility customers. For the avoidance of doubt, ''intrinsically related'' shall include all transactions related to (i) the generation or production, purchase or sale, and transmission or transportation of electric energy or natural gas, or the supply of natural gas and/or electric energy to other utility special entities, or delivery of electric energy or natural gas service to utility customers, (ii) all fuel supply for the utility special entity's electric facilities or operations, (iii) compliance with electric system reliability obligations applicable to the utility special entity, its electric facilities or operations, (iv) compliance with energy, energy efficiency, conservation or renewable energy or environmental statutes, regulations or government orders applicable to the utility special entity, its facilities or operations, or (v) any other electric or natural gas utility operations-related swap to which the utility special entity is a party. Utility operations-related swaps shall **not** *include a swap based or derived on, or referencing, commodities in the interest rates, credit, equity or currency asset classes, or a product type or category in the ''other commodity'' asset class that is based or derived on, or referencing, metals, or agricultural commodities or crude oil or gasoline commodities of any grade not used as fuel for electric generation.* For purposes of this paragraph, if the stated notional amount of a swap is leveraged or enhanced by the structure of the swap, the calculation shall be based on the effective notional amount of the swap rather than on the stated notional amount.

II. The Petitioners

APPA is the national association that represents the interests of approximately 2000 government-owned electric utilities in the United States. APPA's member utilities are not-for-profit utility systems that were created by state or local governments to serve the public interest. Government-owned electric utilities provide over 15% of all KWh sales to retail electric customers.

LPPC is an organization representing 26 of the largest government-owned electric utilities in the nation. LPPC members own and operate over 86,000 megawatts of generation capacity and nearly 35,000 circuit miles of high voltage transmission lines, representing nearly 90% of the transmission investment owned by non-Federal Government-owned electric utilities in the United States.

TAPS is an association of transmission dependent electric utilities located in more than 30 states. All of TAPS member electric utilities except one are government-owned electric utilities.

APGA is the national association that represents government-owned natural gas distribution systems. There are approximately 1,000 public gas systems in 36 states and over 720 of these systems are APGA members. Government-owned natural gas distribution systems are not-for-profit entities owned by, and accountable to, the citizens they serve. They include municipal gas distribution systems, public utility districts, county districts, and other government agencies that have natural gas distribution facilities.

Some government-owned utilities are both electric utilities and natural gas distribution utilities, and are therefore members of both APPA and APGA. The purpose of a government-owned electric utility or natural gas distribution system is to provide reliable, safe and affordable electric energy and/or natural gas service to the community it serves.

BPA is a self-financed, nonprofit Federal agency created in 1937 by Congress that primarily markets electric power from 31 federally owned and operated projects, and supplies over ⅓ of the electricity used in the Pacific Northwest. BPA also owns and operates approximately 75 percent of the high-voltage transmission in the Pacific Northwest. BPA's primary statutory responsibility is to market its Federal system power at cost-based rates to its "preference customers."[11] BPA also funds one of the largest wildlife protection and restoration programs in the world.

III. Nature of the Petitioners' Interest

APPA, LPPC, TAPS and APGA represent thousands of government-owned electric and natural gas utilities throughout the United States, all of which are "special entities" as that term is defined in Section 4s(h)(2)(C) of the Commodity Exchange Act, as amended by the Dodd-Frank Act, and § 23.401(c) of the Commission's regulations.

[11] BPA has 130 preference customers made up of electric utilities which are not subject to the jurisdiction of the Federal Energy Regulatory Commission ("FERC"), including Indian tribes, electric cooperatives, state and municipally chartered electric utilities, and other Federal agencies located in the Pacific Northwest.

BPA and the other Federal power agencies are "special entities" as well.[12] The Petitioners respectfully seek the rule amendment for the benefit of all "Utility Special Entities" that currently, or may in the future, enter into Utility Operations-Related Swaps with counterparties that are not registered with the Commission as "swap dealers."

"Utility Special Entities," as defined in the proposed rule amendment, are a narrow category of special entities distinguishable by their electric energy and/or natural gas utility facilities, operations and public service obligations. None of the Utility Special Entities is a "financial entity;" all are nonfinancial entities and "commercial end-users" as such term is used by Congress and regulatory policy makers. "Utility Operations-Related Swaps," as defined in the proposed rule amendment, are a narrow category of "swaps"[13] in the nonfinancial or "other commodity" asset class. Such swaps are, by definition, of product types intrinsically related to the commercial risks associated with utility facilities, operations and public service obligations, and are used to hedge or mitigate such commercial risks. Such customized nonfinancial commodity swaps are typically not available on exchanges or electronic trading platforms, due to the myriad non-numeric operational conditions, requirements and permutations embedded in such swaps.

The Petitioners commented on the Commission's proposed rules further defining "swap dealer" raising concerns that ***both*** the general *de minimis* threshold and the "special entity sub-threshold" needed to be raised significantly. ***See*** comments filed by NFP Electric End User Coalition, including APPA and LPPC with assistance from TAPS, in the Commission's "Entity Definitions" docket, a link to which appears at: *http://comments.cftc.gov/PublicComments/ViewComment.aspx?id=27917&SearchText=rural* at 18–19, supporting the comments filed by the Edison Electric Institute and the Electric Power Supply Association in the same docket requesting significantly higher thresholds for ***both*** the general *de minimis* threshold and the special entity sub-threshold than were proposed by the Commission, a link to which appears at: *http://comments.cftc.gov/PublicComments/ViewComment.aspx?id=27918&SearchText=*.

The Commission acknowledges the Petitioners' comments in numerous places in the Adopting Release for the Entity Definitions rules (the "Adopting Release"). *See,* for example, 77 *Fed. Reg.* 30627 and 30707. In the final rules, however, the Commission raised the general *de minimis* threshold by a factor of 80 during the phase in period (and by a factor of 30 thereafter)—from $100 million to $8 billion during the phase in period (and $3 billion thereafter). In contrast, the Commission left the special entity sub-threshold unchanged at $25 million. The Petitioners' concern about

[12] According to the Energy Information Administration, there are nine Federal electric utilities in the United States, which are part of several agencies of the United States Government (see, *http://www.eia.gov/cneaf/electricity/page/prim2/toc2.html*): the Army Corps of Engineers; the Bureau of Indian Affairs and the Bureau of Reclamation in the Department of the Interior, the International Boundary and Water Commission in the Department of State, the Power Marketing Administrations in the Department of Energy (BPA, Western Area Power Administration, Southwestern Area Power Administration, and Southeastern Area Power Administration), and the Tennessee Valley Authority (TVA).

In addition, three Federal agencies operate electric generating facilities: TVA, the largest Federal power producer; the U.S. Army Corps of Engineers; and the U.S. Bureau of Reclamation.

[13] This term has not yet been defined by the Commission to the extent required to provide regulatory clarity to Petitioners and others in the utility industry. The Petitioners and others in the utility industry await publication in the Federal Register of rules further defining "swap," along with the Commission's response to public comments on any further questions asked by the Commission in the most recent statutory interpretations relevant to the definition of "swap," the Commission's response to comments solicited on the nonfinancial commodity "trade option" Interim Final Rule, the CFTC/FERC jurisdictional Memoranda of Understanding called for by Section 720 of the Dodd-Frank Act, the "tariffed transaction exemption(s)" and "between FPA 201(f) transaction exemption" called for in new CEA Sections 4(c)(6), and other final rules, interpretations and exemptions. *See* the comment letter filed by the Electric Trade Associations in the "Product Definitions" or "Definition of "Swap" docket at: *http://comments.cftc.gov/PublicComments/ViewComment.aspx?id=47934&SearchText=Wasson*, and other comment letters, applications and petitions filed by the Petitioners and others in the utility industry.

There is no need to wait to consider the proposed rule amendment for the effective date of the Commission's final rules further defining the term "swap." The proposed rule amendment, as drafted, will *only* be applicable to those utility operations-related transactions which are ultimately subject to the Commission's jurisdiction as "swaps," and would therefore be considered part of an entity's "swap dealing activity," and counted against either the general *de minimis* threshold or the special entity sub-threshold. In this manner, the proposed rule amendment is similar to *all* the Commission's regulations that include the term "swap," including the Entity Definition rules themselves. None of these regulations can be fully understood or applied to Petitioners' and other market participants' businesses until the Commission's final rules further defining "swap" and other foundational terms that include the term "swap" are effective for relevant asset classes and product types.

the competitive disadvantage represented by the discrepancy between the two thresholds in the final rules is the reason for this Petition.

A. Utility Special Entities Require Customized Utility Operations-Related Swaps.

Utility Special Entities depend on nonfinancial commodity transactions, trade options and "swaps," as well as the futures markets, to hedge commercial risks that arise from their utility facilities, operations and public service obligations. Together, these nonfinancial commodity markets play a central role in government-owned utilities securing electric energy, fuel for generation and natural gas supplies for delivery to consumers at reasonable and stable prices. Specifically, many government-owned utilities purchase firm electric energy, fuel and gas supplies in the physical delivery markets (in the "cash" or "spot" or "forward" markets) at prevailing and fluctuating market prices, and enter into bilateral, financially-settled nonfinancial commodity swaps with customized terms to hedge the unique operational risks to which each Utility Special Entity is subject.

The Utility Special Entities use Utility Operations-Related Swaps to ensure reliability of utility service and to reduce utility customers' exposure to future commodity price fluctuations and to stabilize utility rates. In hedging, mitigating or managing the commercial risks of its utility facilities operations or public service obligations, the Utility Special Entity are engaged in commercial risk management activities that are no different from the operations-related hedging of an investor-owned utility or an electric cooperative located in the same geographic region.

B. The "Market" for Each Particular Utility Operations-Related Swap is Illiquid.

Utility Special Entities enter into these bilateral customized swaps in illiquid regional or local "markets." [14] Some counterparties available to transact with Utility Special Entities will be major financial institutions or other financial entities, such as hedge funds, that may or may not transact in other swap asset classes or product types. Other available counterparties will be nonfinancial counterparties, those which are not "financial entities" as such term is defined in CEA Section 2(h)(7)(C).

Each Utility Special Entity actively seeks out available swap counterparties in order to hedge its unique, ongoing and dynamically-changing commercial risks.[15] Commercial risk management policies in the energy industry typically require diversification of suppliers and swap counterparties, limited concentration of supplier/vendor/counterparty credit risk, and other commercial risk management metrics to prudently manage the commercial risks of bilateral contracting processes.

Each regional geographic market has a somewhat different group of financial entity and nonfinancial counterparties available to enter into customized Utility Operations-Related Swaps. An available counterparty may own or operate commercial businesses related to the particular nonfinancial commodity that underlies the Utility Operations-Related Swap. It may be a neighboring utility or electric cooperative, the owner of a merchant electric generation facility located in the area, or a natural gas or coal company with production assets in the region.

For example, a large natural gas utility or the owner of a large merchant electric generation station in western Alabama might be available as a nonfinancial counterparty for swaps referencing an Alabama delivery point. But that same entity would not necessarily offer the type of customized Utility Operations-Related Swap required by a Utility Special Entity located in Oregon. Or, a natural gas producer or coal producer with production assets in Wyoming might offer Utility Operations-Related Swaps required by a California-based or Oregon-based Utility Special Entity. But the same counterparty would not necessarily enter into a similar Utility Op-

[14] The word "markets" is used in quotations in this context, as Utility Operations-Related Swaps do not occur with anywhere near the frequency or uniformity that financial "swaps" occur, or that agricultural, metals, global oil or other product types of "swaps" in the "other commodity" asset class occur. Utility Operations-Related Swaps are, in some cases, negotiated over a period of days, weeks or months. Some may be documented based on a master agreement template, with many pages of specialized operational, credit and other risk management provisions included by the bilateral counterparties as schedules. Transacting under standardized master agreement templates (with bilaterally negotiated schedules and transaction documents) should not be confused with a conclusion or an assumption that there is a trading "market" for Utility Operations-Related Swaps having, standardized or "market" terms.

[15] Utility Special Entities may also be called upon from time to time by other utilities located in the same geographic region, by or in coordination with electric reliability organizations, to act as counterparties in Utility Operations-Related Swaps for electric system reliability purposes. Such swaps should not be considered "swap dealing activity" by the utility counterparty or counterparties to such swaps. Otherwise, the Utility Special Entities may not be able to participate in such swaps for reliability purposes without causing the counterparty to exceed the Special Entity Sub-Threshold, which may compromise the reliability of the interconnected electric system.

erations-Related Swap referencing a nonfinancial commodity delivered in the Southeast. Nor would it necessarily offer a Utility Operations-Related Swap referencing electric energy in any regional market.

C. Utility Special Entities Need All Available Utility Operations-Related Swap Counterparties.

Due to the limited number of counterparties for any particular Utility Operations-Related Swap in any particular region, each available financial or nonfinancial swap counterparty, whether or not a registered "swap dealer," brings important market liquidity or supplier/counterparty diversity for a Utility Special Entity. Multiple available counterparties create price competition for the customized swaps that a Utility Special Entity requires to cost-effectively hedge or mitigate unique commercial risks.[16]

Based on an informal survey of some of the larger Utility Special Entities, a substantial percentage of the counterparties that are currently available to enter into Utility Operations-Related Swaps with such Utility Special Entities are nonfinancial entities engaged in the electric, natural gas, coal or another aspect of the energy industry in the same geographic area as the specific Utility Special Entity.

Wall Street financial institutions and other financial entities tend to offer such swaps only where there is standardization of transaction terms and liquid trading markets: at trading hubs where the financial entity's swaps can be promptly and effectively hedged to maintain a "balanced book." Nonfinancial entities with assets or operations located in the geographic region may, as a result, face parallel commercial risks and can use the Utility Operations-Related Swap to manage some portion or aspect of the commercial risks inherent in its own physical assets, liabilities and commercial obligations.[17]

Because the Utility Special Entity is hedging a commercial risk, its focus is to align the Utility Operations-Related Swap as closely as possible with the underlying and unique commercial risk being hedged, rather than to settle for a more standardized, shorter-term, and therefore less "perfect" (and consequently less cost-effective) hedge for such commercial risk.[18]

D. Utility Operations-Related Swaps Often Have Large Notional Amounts.

Many Utility Operations-Related Swaps have longer terms than may be typical in other swap asset classes or product types, as a result of the long-term commercial risks being hedged—risks arising from long-term utility service obligations, construction projects, generation outage or availability projections, or long term fuel needs. Consequently, the notional amount of such swaps can be quite large. In addition, due to the volatile nature of the market prices of these nonfinancial commodities, the notional amounts can fluctuate dramatically over the term of a Utility Operations-Related Swap. The prices of electric energy, fuel and natural gas are among the most volatile of traded commodities, especially prices for illiquid delivery points, subject to regional supply and demand factors such as weather, and with customized operational conditions and terms.

A single 1 year 100 MW swap or a single 3 year 10,000 mmBtu/day swap may have a notional value of $25 million.[19] A nonfinancial entity would, therefore, be

---

[16] In the Adopting Release, the Commission cites comments made by Petitioners' representatives and other energy industry market participants at the Commission Roundtable and meetings on these important points. See 77 *Fed. Reg.* at 30707–30708. Although a Utility Special Entity may be able to seek out a CFTC-registered Wall Street "swap dealer" or another financial entity, such as a hedge fund, to provide such a customized Utility Operations-Related Swap, if the "swap dealer" does not have assets in the region or is not otherwise active in the particular regional nonfinancial commodity swap market, the pricing and customization of the Utility Operations-Related Swap it offers are unlikely to be competitive.

[17] The nonfinancial counterparty may itself be entering into a Utility Operations-Related Swap "for the purpose of hedging physical positions," as that phrase appears in CFTC Regulation 1.3(ggg)(6)(iii) and about which the Commission is seeking further comment in the Adopting Release. That regulation is identified as an "interim final rule," and therefore presumably is still subject to further Commission rulemaking before the rules defining "swap dealer" are, indeed, final. See 77 *Fed. Reg.* 30612. See also footnote 6 with reference to the Commission's anticipated further rulemakings on the definition of "swap" and nonfinancial commodity "trade options."

[18] We have discussed the Special Entity Sub-Threshold issue with energy trade associations and with large nonfinancial entities that currently act as regular counterparties to Utility Special Entities in these types of swaps. A number of these entities have indicated to Petitioners that they share our concern about the sub-threshold, and that they are prepared to file comments in support of this Petition. See footnote 16.

[19] These examples are based on available quotes for 100 MWs of 7x24 electric energy for calendar year 2013 at Mid-C, PJM West and SP–15 for "Firm LD" power, and on Henry Hub calendar strip prices for natural gas. Each of these examples is for a relatively liquid delivery

Continued

available to enter into only one such swap with Utility Special Entity counterparties in any rolling twelve-month period. Otherwise, the nonfinancial entity risks exceeding the special entity sub-threshold, and would be required to register with the Commission as a "swap dealer."

E. Utility Special Entities are At a Competitive Disadvantage to Similarly-Situated Market Participants due to the Special Entity Sub-Threshold.

If the Commission denies the proposed rule amendment, Utility Special Entities could still look to CFTC-registered swap dealers for these types of swaps, or could use less customized, more expensive commercial risk management solutions that might be available on an exchange. Or Utility Special Entities could simply forego using nonfinancial commodity swaps for commercial risk management purposes entirely. At the same time, the available counterparties for Utility Operations-Related Swaps could enter into up to $8 Billion notional in swaps, or even $8 Billion in Utility Operations-Related Swaps, with counterparties ***other than*** Utility Special Entities, including neighboring investor-owned utilities and electric cooperatives. As a direct result of the Special Entity Sub-Threshold, Utility Special Entities are denied a level playing field in the competition for available counterparties for these commercial risk hedging swaps. Utility Special Entities are denied comparable, cost-effective access to such commercial risk management tools that will instead be offered to neighboring investor-owned utilities and electric cooperatives by otherwise available market participants.[20]

In today's regional markets, a Utility Special Entity is equally as likely as an investor-owned utility in the same region to be an attractive counterparty for an entity that chooses to "deal" in Utility Operations-Related Swaps, whether the entity is a nonfinancial company hedging its own commercial risks (or "hedging a physical position" as such phrase is more narrowly defined in the CFTC's definition of "swap dealer"), trading for profit (speculating), or engaging in a regular business of dealing in such swaps. The "playing field" between the Utility Special Entity and the investor-owned utility, electric cooperative or any other counterparty is currently "level."

Moreover, in today's regional markets, if a market participant (such as the Alabama merchant generator or the Wyoming natural gas or coal producer referenced above) is considering establishing a new entrant "swap dealing" business in specific regional product types of Utility Operations-Related Swaps, it will similarly consider the Utility Special Entity as a potential counterparty with the same ability to transact as any other potential counterparty. The Utility Special Entity benefits from any new or additional price competition.

Once the CFTC's Entity Definition rules are effective, as a result of the significant disparity between the general *de minimis* threshold and the special entity sub-threshold, the Alabama-based merchant generator or the Wyoming-based natural gas or coal producer, or any other market participant not intending to register as a "swap dealer," will substantially limit its swap dealing activity in Utility Operations-Related Swaps with Utility Special Entities. Indeed, in regions like California and the Southeast United States, where there are geographic concentrations of Utility Special Entities, a non-"swap dealer" counterparty may only be able to execute one such Utility Operations-Related Swap with one such Utility Special entity in a 12 month period without the risk of exceeding the $25 million sub-threshold. The entity will set up its swap dealing activity business, its business processes, its docu-

point, and for swaps that are not customized as are many Utility Operations-Related Swaps. To put these examples (and the $25 million Sub-Threshold) in context, the Los Angeles Department of Water and Power owns or operates 6,000 MWs of electric generation, and the New York Power Authority owns or operates 7,400 MWs of electric generation. JEA, formerly the Jacksonville Electric Authority, hedges approximately 13.8 million mmBtus of natural gas in an average year as part of its fuel procurement process for electric operations, based on the past 5 years actual hedging activity. If each of these Utility Special Entities was limited to one $25 million hedge per year with each non-"swap dealer" counterparty, it would dramatically limit the ability of these Utility Special Entities to hedge or mitigate commercial risks arising from everyday utility operations.

[20] An unintended consequence of the $25 million Special Entity Sub-Threshold applied to Utility Operations-Related Swaps will be to limit the Utility Special Entities' available counterparties and force Utility Special Entities to engage in Utility Operations-Related Swaps with financial institutions and other entities that are registered with the CFTC. This would concentrate, not disperse, risk to the United States financial system. For financial institutions, such activity may or may not be an activity in which such financial institutions or their "banking entity" affiliates are permitted to engage once the regulations implementing the Volcker Rule and other provisions of the Dodd-Frank Act rulemakings are finalized. Such Utility Operations-Related Swaps with "swap dealer" counterparties may also require the posting of margin by Utility Special Entities (depending on the applicable regulators' final rules on capital and margin).

mentation and its compliance programs to transact with counterparties ***other than*** the Utility Special Entities, including neighboring investor-owned utilities and electric cooperatives.[21] The unworkably low, and comparatively disadvantageous, Special Entity Sub-Threshold threatens the Utility Special Entities' uninterrupted access to these important and cost-effective commercial risk management tools.

IV. Supporting Arguments

For the following reasons, the Commission should approve the proposed rule amendment as soon as possible:

A. The Commission has the Authority to Approve the Rule Amendment.

Section 1a(49)(D) of the Commodity Exchange Act ("CEA") as amended by the Dodd-Frank Act, and new CFTC Regulation 1.3(ggg)(4)(v) authorize the Commission to change or modify the requirements of the *de minimis* exception to the "swap dealer" definition by rule or regulation, without engaging in further joint rulemaking or joint interpretative guidance with the Securities and Exchange Commission. The Adopting Release acknowledges this. See footnote 464 at 77 *Fed. Reg.* 30634, and related text.

Section 1a(49)(D) provides as follows:

> ". . . (D) *DE MINIMIS* EXCEPTION.—The Commission shall exempt from designation as a swap dealer an entity that engages in a *de minimis* quantity of swap dealing in connection with transactions with or on behalf of its customers. The Commission shall promulgate regulations to establish factors with respect to making of this determination to exempt."

As the Commission notes on page 30702 of the Adopting Release, ". . . CEA Section 1a(49)(D) directs the CFTC to promulgate regulations to establish factors with respect to the making of the determination to apply the *de minimis* exceptions to the definition of the term 'swap dealer.'"

New CFTC Regulation 1.3(ggg)(4)(v) provides as follows:

> ". . . (v) FUTURE ADJUSTMENTS TO SCOPE OF THE DE MINIMUM EXCEPTION. The Commission may by rule or regulation change the requirements of the *de minimis* exception described in paragraphs (ggg)(4)(i) through (iv) of this section."

Clearly the Commission has the authority to approve the proposed rule amendment.

B. The Factors Set Forth the Proposed Rule Amendment are Distinctly and Uniquely Applicable to Utility Operations-Related Swaps and to Utility Special Entities.

The proposed rule amendment will have no affect on the *de minimis* exception to the "security-based swap dealer" definition. Nor will the proposed rule amendment have any affect on the *de minimis* exception to the Commission's "swap dealer" definition as it applies in general to special entities (including Utility Special Entities) engaging in financial swaps or nonfinancial "other commodity" swaps, other than those product types critical to hedging or mitigating commercial risks in the utility industry.

The factors set forth in the proposed rule amendment are not applicable to security-based swap dealers or to their counterparties. Counterparties to security-based swaps do not need such security-based swaps to "hedge or mitigate commercial risks", as is the case with commercial end-users' need for nonfinancial commodity swaps to hedge or mitigate commercial risks. Congress specifically recognized the importance of protecting "commercial end-users" access to nonfinancial commodity swaps when it emphasized that the Dodd-Frank Act's focus on financial market stability and price and market transparency should not be achieved without *also* preserving commercial end-users' access to swaps used to hedge or mitigate commercial risks.[22]

The factors that argue in favor of the Commission approving the proposed rule amendment are also inapplicable to entities involved in agricultural or metal commodities transactions and swaps. Such entities are simply not subject to public serv-

[21] The Adopting Release notes that the statute's *de minimis* exception intended to *increase* competition within markets for swaps by encouraging new entrants, thereby decreasing costs for commercial end-users and decreasing systemic risks by lessening concentration of dealing activity among a few major financial market participants. See 77 *Fed. Reg.* 30629. Ironically the special entity sub-threshold acts directly contrary to this stated statutory and regulatory objective. For Utility Special Entities hedging commercial risks, the sub-threshold will serve to *discourage* new entrants and *concentrate* the Utility Special Entity's counterparty credit risk. The proposed rule amendment would restore this competitive, and less risky, market structure.

[22] *See* 156 CONG. REC. H5238 (the "Dodd-Lincoln letter").

ice obligation comparable to those that apply to utilities that require Utility Operations-Related Swaps to hedge commercial risks associated with utility facilities, operations and public service obligations. Utilities (including Utility Special Entities) have public service obligations under Federal, state and local laws and regulations, and utility reliability obligations, that other industries simply do not share. Congress recognized these important obligations throughout the Dodd-Frank Act as deserving of the Commission's regulatory deference. See Section 720 of the Dodd-Frank Act calling for FERC/CFTC Memoranda of Understanding, new CEA Section 2(a)(1)(I) regarding jurisdiction of the various energy regulatory agencies, and new CEA Section 4(c)(6) directing the Commission to consider public interest waivers of its jurisdiction.

The Commission clearly has the authority to approve the proposed rule amendment. The factors that argue in favor of the proposed rule amendment, and limit its affect, reflect the unique and the different characteristics of these types of "swaps" and these market participants, and recognize the differing applicable laws and regulations, and statutory and regulatory policies The Commission should approve the proposed rule amendment and do so as soon as possible.

C. Nothing in the Dodd-Frank Act or the CEA Requires the Special Entity Sub-Threshold.

The proposed rule amendment is narrowly tailored to achieve both the statutory goals and Congressional intent underlying the Dodd-Frank Act, and to leave in place the supplemental investor protection objectives of the Commission in including the Special Entity Sub-Threshold in the "swap dealer" definition.

In the Dodd-Frank Act, Congress imposed on registered "swap dealers" heightened business conduct standards when advising, offering or entering into swaps with "special entities." Nothing in the Dodd-Frank Act imposes or requires the Commission to impose business conduct standards on entities that are not required to register as "swap dealers." Nothing in the Dodd-Frank Act requires the Commission to impose an exponentially smaller *de minimis* sub-threshold for counterparties that are not registered "swap dealers" and that enter into swaps to which "special entities" are counterparties. The Adopting Release acknowledges as much, characterizing the lower threshold as "*consistent with* the fact that Title VII's requirements applicable to swap dealers . . . provide heightened protection to these types of entities." 77 *Fed. Reg.* at 30630 (emphasis added).

The Adopting Release cites the Dodd-Frank Act provisions that impose on *registered* swap dealers and major swap participants (those market professionals whose activities are directly regulated by the Commission) heightened business conduct standards and documentation requirements for interacting with "special entities." The Adopting Release then extrapolates without explanation as to why it is consistent for the Commission to extend its regulatory reach beyond the market professionals registered as "swap dealers," whose conduct the statute intends it to regulate, to impose restrictions on the activities of entities that are not swap dealers, and whose *de minimis* "swap dealing activities" do not require such registration. The Special Entity Sub-Threshold is a clear regulatory overreach by the Commission, and should be modified where such regulatory overreach negatively affects the ability of yet another group of entities that are not "swap dealing"—the "Utility Special Entities"—to hedge or mitigate the commercial risks of their nonfinancial, public service enterprises.

The Adopting Release gives examples of situations where the special entity "lacked the requisite sophistication and experience to independently evaluate *the risks of the investment* and exposed the [special entity] to a heightened risk of catastrophic loss ultimately led to a complete loss of their investments." See footnote 425 and text accompanying at 77 *Fed. Reg.* 30630 (emphasis added). In the examples, the special entities were acting outside the scope of their core operations as investors in financial derivatives, interacting with financial institution or "financial entity" market professionals, using cash reserves or other cash assets of the special entity to invest (for profit or loss) in financial derivatives instruments. By contrast, the Utility Special Entities use Utility Operations-Related Swaps to hedge the commercial risks of their core utility operations, not to invest for profit.

D. The Proposed Rule Amendment is Consistent with Both Congressional Intent of the Dodd-Frank Act and Will have No Affect on the Commission's Investor Protection Policy Objectives.

The investor protection objectives of the Dodd-Frank Act, and the Commission's own "consistent" and supplemental investor protection objectives as expressed in the Adopting Release, would not be affected or compromised by the proposed rule amendment. As is clear from the proposed definition of "Utility Operations-Related

Swap," the Utility Special Entity enters into such a nonfinancial commodity swap to hedge commercial risks that arise from its utility facilities, operations and public service obligations.

The proposed rule amendment is drafted narrowly to respect the Commission's investor protection policies but to achieve the distinct, but equally important, Congressional intent of the Dodd-Frank Act: to preserve cost-effective (and comparative, competitively equal) access to nonfinancial commodity swaps that Utility Special Entities use "to hedge or mitigate commercial risks."

The proposed rule amendment does not amend either the general *de minimis* threshold for swap dealing activity. The general *de minimis* threshold would continue to apply to Utility Operations-Related Swaps to which Utility Special Entities are counterparties. Nor does the proposed rule amendment change the "special entity sub-threshold" for swaps in asset classes or product types other than Utility Operations-Related Swaps to which Utility Special Entities are counterparties.

In defining the term "Special Entity" in Section 4s(h)(2)(C) of the Dodd-Frank Act and establishing the heightened business conduct standards for registered "swap dealers," Congress did not intend for the Commission expand its regulatory oversight beyond oversight of regulated "swap dealers" to place restrictions on entities that are *not* required to register as "swap dealers." In establishing the Special Entity Sub-Threshold and then not substantially raising it when it raised the general *de minimis* threshold, the Commission restricted Utility Special Entities' competitive abilities, and severely restricted Utility Special Entities' access to the nonfinancial commodity swaps needed to cost-effectively hedge or mitigate commercial risks.

V. Process and Timeline for Petition

The Petitioners respectfully request the Commission to act as soon as possible on the proposed rule amendment—to remove continuing regulatory uncertainty for the Utility Special Entities and counterparties that would, but for the Special Entity Sub-Threshold, be available to enter into Utility Operations-Related Transactions with Utility Special Entities. As the Commission's new "swap" regulations are proposed, become final and implementation begins, market participants are evaluating whether and how to participate in the new market structure for "swaps." At the same time, Utility Special Entities have continuing utility public service obligations to provide affordable, reliable utility service to their customers, and consequently have both short-term and long-term commercial risks to hedge.

As the effective dates and compliance dates approach for the new "swap" regulatory regime, market participants are beginning to turn their attention away from current activities in nonfinancial commodities and commodity swaps in general. The challenges of the new regulatory requirements applicable to "swaps," including challenges for systems, staffing, compliance, documentation and reporting are overwhelming, even for the largest financial institutions and financial markets professionals, especially given the tight and interrelated compliance timelines.

The added challenge of determining whether to register as a "swap dealer" for one or more asset classes or product types of "swaps" are even more daunting for a nonfinancial entity, whose primary and ongoing business is not trading or investing or dealing in the financial markets, but drilling for natural gas, mining coal, or generating, transmitting and/or delivering electric energy or natural gas to consumers.[23]

[23] A number of the nonfinancial entities with whom the Petitioners (or the trade association Petitioners' members) transact in Utility Operations-Related Swaps have told us that they are currently evaluating their nonfinancial commodity "swap" activities in light of the final Entity Definitions rules, the Interim Final Rule in Section 1.3(ggg)(6)(iii), and the statutory guidance provided in the Adopting Release and elsewhere in the CFTC's regulations, interpretations and precedents. Such nonfinancial entities are also awaiting the CFTC's final rules defining the term "swap," which is the foundational rulemaking which will enable the energy industry to understand the scope of the CFTC's jurisdiction over our industry's transactions. As of July 10, 2012, for the electric and natural gas utility industry, the challenges are compounded by the continuing uncertainty as to what is and isn't a "swap," a "nonfinancial commodity forward" transaction, a nonfinancial commodity forward with embedded optionality, or a "trade option." See footnote 6 above. Once the rules defining "swap" are final with respect to our industry's transactions, each nonfinancial entity will then (and can only then) analyze which of its activities will fall within the definition of "swap," and therefore would or could be "swap dealing," which of its activities will be excluded as "hedging a physical position" (depending on the outcome of that final rulemaking), or fit within other safe harbors under the interpretive guidance provided by the Commission. Then and only then can the nonfinancial entity decide, as a business matter, whether to continue all or any of its swap dealing activities, and whether to register as a "swap dealer" or to register for a limited designation as a "swap dealer" for certain asset classes and product types (that may or may not include particular Utility Operations-Related Swaps).

Continued

If a market participant decides to continue some amount of "swap dealing activity" in Utility Operations-Related Swaps, it will carefully evaluate and then establish compliance procedures to monitor the two *de minimis* thresholds. In doing so, it will certainly hesitate or delay incurring the expense of setting up specially calibrated systems, compliance processes and staff training in order to engage in one or two such swaps with Utility Special Entities within a 12 month period. A nonfinancial counterparty that does not choose to register as a "swap dealer" will instead understandably focus on modifying its business processes and documents to engage in swaps with counterparties other than Utility Special Entities, under the general *de minimis* exception threshold.

We request that the Commission promptly publish the proposed rule amendment for comment in the *Federal Register,* without waiting for the effective date of the Entity Definitions rules. We recommend a public comment period of no longer than 20 days, and respectfully request publication of the Commission's final approval or grounds for denying the rule amendment within 10 days thereafter.[24] The Petitioners request that the amended rule be retroactive and prospective for all Utility Operations-Related Swaps to which a Utility Special Entity is a counterparty entered into after the effective date of the Entity Definition rules.

VI. Conclusion

The Petitioners respectfully petition the Commission under CFTC Regulation 13.2 to amend CFTC Regulation 1(ggg)(4), which implements the *de minimis* exception to the definition of "swap dealer," as described above.

Signature Page—Special Entity Sub-Threshold Petition

Please contact any of the individuals below or Patricia Dondanville, Reed Smith LLP, 10 South Wacker Drive, 40th Floor, Chicago Illinois 60606, telephone (312) 207–3911, or e-mail *pdondanville@reedsmith.com,* if you have questions regarding this Petition.

Respectfully submitted,

American Public Power Association

Susan Kelly

SUSAN KELLY
Senior Vice President of Policy Analysis and General Counsel

1875 Connecticut Avenue, N.W.
Suite 1200
Washington, D.C. 20009–5715
Tel: (202) 467–2933
E-mail: *skelly@publicpower.org*

Large Public Power Council

Noreen Roche-Carter

NOREEN ROCHE-CARTER
Chair, Tax and Finance Task Force
c/o Sacramento Municipal Utility District
6201 S Street
Sacramento, CA 95817–1899

Tel: (916) 732–6509
E-mail: *nrochec@smud.org*

Transmission Access Policy Study Group

John Twitty

JOHN TWITTY
Executive Director
4203 East Woodland Street

Springfield, MO 65809

American Public Gas Association

David Schryver

DAVID SCHRYVER
Executive Vice President
201 Massachusetts Avenue, NE
Suite C–4
Washington, DC 20002

Alternatively, only then can such a nonfinancial entity alternatively decide to wind down any swap activities which the Commission might consider to be "swap dealing activities." Nothing requires a nonfinancial entity (whose primary business is *not* to engage in financial markets transactions like "swaps") to continue its past or current business strategies. If a particular nonfinancial entity decides to continue some level of swap dealing activity, it may decide *not* to continue such activity as a registered "swap dealer." At last decision point, once the new Dodd-Frank Act rules are effective and as compliance dates approach, these entities will restrict their swap dealing activity to stay well below the two very different *de minimis* exception thresholds in the CFTC's swap dealer definition.

[24] The proposed rule amendment relieves a competitive restriction on Utility Special Entities, and modifies the special entity sub-threshold to the *de minimis* exception to the definition of "swap dealer." The Commission and interested persons in the electric and natural gas industry have been on notice of the Utility Special Entities' concerns since early May 2012. As a result, the proposed rule amendment is entitled to the earlier effective date permitted by CFTC Regulation 13.6.

Tel: (414) 838–8576
E-mail: *835consulting@gmail.com*

Tel: (202) 464–0835
E-mail: *dschryver@apga.org*

Bonneville Power Administration

Virginia Schaeffer

VIRGINIA K. SCHAEFFER
Attorney
Office of the General Counsel—LC–7
P.O. Box 3621
Portland, Oregon 98208–3621
Tel: (503)230–4030
E-mail: *vkschaeffer@bpa.gov*

CC:
Honorable GARY GENSLER, *Chairman*
Honorable BART CHILTON, *Commissioner*
Honorable JILL E. SOMMERS, *Commissioner*
Honorable SCOTT O'MALIA, *Commissioner*
Honorable MARK WETJEN, *Commissioner*
Office of the CFTC General Counsel

The CHAIRMAN. Thank you for your testimony, and I would note to my colleagues on the Committee that at approximately 1:05, maybe 1:15, we will begin a series of votes, so we will endeavor to conclude all of our business in a timely fashion. I recognize myself for 5 minutes.

Mr. Duffy, does the CME's recent designation by the FSOC and the regulatory requirements associated with it put CME in a better position to hold customer segregated funds instead of a third-party custodian?

Mr. DUFFY. Well, I don't know if the designation has anything to do with CME or a third party holding the funds. You know, this is something that we had put out there just to—we don't have all the details worked out yet. We still believe that the FCMs are very capable of holding the customer funds, but at the same time, we know there needs to be confidence in the marketplace so if in fact the customers felt safer with CME Group or a third-party depository, we would be prepared to move forward with that.

The CHAIRMAN. Very good point.

Mr. Roth, your testimony states that you began an examination of PFGBest in mid-June. Was it a scheduled audit or inspired by some anomaly?

Mr. ROTH. The audit that we began in mid-June was part of our regular cycle of audits for FCMs where we try to see each FCM each year. I don't want to suggest that that is the only time we ever examined PFG. We had a number of limited-scope audits involving sales practice-type issues and their supervision of IBs but the June audit was part of the regular cycle.

The CHAIRMAN. For the regular audits that you conducted of PFGBest, was Mr. Wasendorf, Sr. ever personally involved in those audits?

Mr. ROTH. When we would ask questions of staff, I am sure there were certain questions that we posed to staff that were answered by Mr. Wasendorf, Sr. I can't say specifically which questions were directed to him and which were to the chief compliance officer or the chief financial officer. It would not surprise me if we had posed certain questions directly to Mr. Wasendorf.

The CHAIRMAN. Based on NFA's internal investigations of PFGBest, was this a Ponzi scheme in the classic sense?

Mr. ROTH. It is a distinction that no one but a regulator would care about. It is not a Ponzi scheme in the sense that they were reporting false profits to customers and paying old customers off with new customer money. It was really just more of an outright theft of customer funds.

The CHAIRMAN. Thinking about the description both in your written testimony and your oral, do you believe that more than one person would be required to be involved in such a defrauding of customers and regulators alike. I mean, getting both the customers and the regulators is a pretty impressive accomplishment.

Mr. ROTH. You know, obviously there is an ongoing investigation conducted by the Justice Department. I don't have any firsthand facts. I can just tell you that the volume, the sheer volume of forged documents produced on a daily basis was fairly staggering, and again had to be produced on a daily basis, and Mr. Wasendorf obviously traveled occasionally and wasn't in the office, but I really don't have any firsthand knowledge. I hope that the investigation will ultimately uncover that.

The CHAIRMAN. Thank you.

Mr. Lukken, the CFTC and the SEC have different approaches to writing and disseminating rules as required by Dodd-Frank. CFTC has formalized the rules basically one at a time, in some cases involving an effective date until 60 days after issuing the final rules on the *entity* or the *product* definitions. The SEC, on the other hand, is holding rules basically until all of the rules are completed. It will then issue a sequencing document, as I understand it, and solicit public comment. Which agency approach is right? You have a little bit of insight here. And why?

Mr. LUKKEN. Well, as I mentioned, the Dodd-Frank implementation, although conceptually most people are in agreement with what came out of the G20 commitment in Pittsburgh after the financial crisis, but the implementation of that has been very tricky and complex within the industry. As I mentioned in my testimony, the SEC has actually put forward a good way to try to give certainty to the industry of how they are going to implement this rather than devote resources, time and energy potentially wasted if you are either in and it turns out that you are out and you may devote resources unnecessarily, or the opposite where you are caught, where you think you are not in, but you turn out to be in. The SEC seems to have taken a logical approach, a measured approach, and I would encourage the CFTC to do the same.

The CHAIRMAN. Mr. Heck and Mr. Conner, I believe we all heard together here today the CFTC Chairman indicate that he would address the issues pertaining to the recording of farmers' conversation as it comes to contracts. Do you find that to be a reassuring public, stressing public, statement by the Chairman in that regard?

Mr. CONNER. Mr. Chairman, I do, and we have worked very closely with Chairman Gensler throughout the rulemaking process and he has been good to his word, and he was pretty clear today. We look forward to seeing the follow-through on that on what we think is really a pretty absurd concept, when you really get down to putting it in place out there on the ground.

Mr. HECK. I believe, Mr. Chairman, at the NGFA, we would agree with Mr. Conner's comments. I think the CFTC is open to dialogue on this point and we will certainly take advantage of that.

The CHAIRMAN. Mr. McElroy, with my colleagues indulging me for one last question on the final swap rule, you mentioned the public power and public gas utilities and the new costs and how that will be moved on down to the ratepayers, because ultimately that is who pays the bills in regards to utilities. One last question, and it is more rhetorical and you can answer if you care to. What did the customers of public power and gas companies have to do with the financial crisis to deserve this?

Mr. MCELROY. That is a question we have asked over and over again, and we don't have a good answer for that.

The CHAIRMAN. My time has expired. I turn to the fine gentleman from Iowa for his 5 minutes.

Mr. BOSWELL. Well, thank you, Mr. Chairman, and I just—again, our earlier dialogue, you got it right what you were trying to do as far as the authorization committee but the appropriations side of it is a concern of mine, and I kind of want to talk about that just a little bit.

First off, I guess I will go to Mr. Roth. Mr. Wasendorf had been a member of the NFA advisory committee and the chief compliance officer of this had been a senior compliance officer at NFA as well. It indicates to me in looking at the magnitude of this whole thing, there must be quite a few, or could be quite a few others implicated. What is your thought about that, and if you think there could be others, what are we doing to find out?

Mr. ROTH. Well, let me first state with respect to the chief compliance officer, she had been a former employee of NFA but she left NFA 15 years ago, so that is a pretty long departure. I don't think any of the people that were involved in our audits had overlapped with her at NFA.

Mr. BOSWELL. So her information having been on the inside wouldn't necessarily be applicable to how she would try to defraud us now?

Mr. ROTH. Well, obviously, the procedures that we follow now aren't the procedures that we followed 15 years ago, but I would also point out, I think there were reports trying to portray her as having been a high-level executive at NFA, and she wasn't. She was a member of the compliance department but she didn't have any sort of senior management position at all.

You mentioned Mr. Wasendorf's position on our FCM advisory committee. The FCM advisory committee is a committee that does just that. It has no authority to take any action. It advises the board on any such rulemaking issues that are coming before the board. Mr. Wasendorf was one of the nine or ten members on that committee.

Mr. BOSWELL. Okay. I am satisfied with that answer.

Again, the magnitude, it seems to me like there has to be a lot of people involved in this day-to-day operation of the fraud that took place.

Mr. ROTH. Congressman, one point, when we talk about preventing this type of fraud in the future, and I have tried to describe the steps we are taking to really make the surveillance of customer segregated funds as tight as we possibly can, but let me just mention an obvious point, I guess. One way to prevent fraud is to deter fraud through vigorous prosecutions of the laws that are on the books now, and everybody would agree with that and I would certainly hope that the ongoing investigation conducted by the Justice Department will uncover all the evidence and ultimately make that judgment as to whether other people were involved or not.

Mr. BOSWELL. Well, I also in our conversation understand that because of your funding system, you are actually expanding the size of your operation, personnel, equipment and so on. To what extent are you expanding and where do you intend to go?

Mr. ROTH. I would say that over the last 5 to 6 years, we have had a 33 percent increase in the size of our compliance department just because of increased demands. Our budget this year that was just approved by the board calls for a 27 percent increase in administrative spending. That is in anticipation of the increased responsibilities under Dodd-Frank. We frankly anticipate we will——

Mr. BOSWELL. Thank you. I understand it well.

And then I guess it picks up, Mr. Chairman, my point is, how does CFTC do their job, and I continue to be concerned about that.

Mr. Conner, I haven't seen you for a while. You know my respect and appreciation for co-ops and farmers and ranchers and what it means to us, and I would guess that we have a lot of people out there that were involved in this recent thing that have really been whacked pretty hard. Would you agree to that?

Mr. CONNER. Well, we certainly know we have members and farmer-owners, Congressman, who were caught up in the MF Global circumstance. I think it is a little too early to say in the other Sioux City circumstance exactly the impact but certainly you can expect some.

Mr. BOSWELL. You heard Mr. Roth—thank you, Mr. Roth, for your straightforwardness about how you intend to expand and how you are doing it and so on. Are the rest of you, are you doing the same thing? And also today's electronics, are you actually looking at what the bank is doing as you look at the reports you are getting back? Are you doing that now? Maybe you might comment on that, any and all.

Mr. DUFFY. Well, Mr. Boswell, at the CME, we are working in conjunction with the NFA and the CFTC to have that ability to go ahead and look straight through into the bank records.

Mr. BOSWELL. You are looking at it, but are you doing it?

Mr. DUFFY. We have the ability today to call the FCM and say we want to have a look at the bank statement to make sure the monies are there. Now, it will go on a more real-time basis but at the moment right now we can today as of recently go ahead and deploy this technology.

Mr. BOSWELL. My time is running out, but any of the rest of you doing it any different than what we just have heard?

Mr. LUKKEN. I wouldn't say differently but the FCMs, the problem needs to be solved at all levels, at the Federal regulatory level, and Chairman Gensler testified this morning that he is looking at this, at the self-regulatory level, but the firms themselves who our trade association represent. They are implementing internal controls, making sure there is separation of duties between CFOs and compliance people, making sure that all the controls are in place and disclosures are happening so that this can be ferreted out earlier so that this doesn't occur over a 20 year period of time.

Mr. BOSWELL. Mr. Chairman, my time is up. Could we indulge the rest of them to see if they want to comment on that particular question?

The CHAIRMAN. The panel is most welcome to address any thoughts to the Member's question they care to.

It looks like the gentleman's time has expired.

Mr. BOSWELL. Thank you.

The CHAIRMAN. The chair now recognizes the gentleman from Florida for 5 minutes.

Mr. SOUTHERLAND. Thank you, Mr. Chairman.

I have to take a deep breath because you guys have some major problems, and it would be very convenient to blame the lack of regulation. You know, I have been a state regulator or appointed to serve as Chairman of regulatory boards. Mr. Lukken, you mentioned educating customers. Well, that is great. That is great. You mentioned that with depressed futures volumes, historically low interest rates and an ultracompetitive pricing model, FCMs are under tremendous strain financially. Well, bless your heart. My heart bleeds for you. I am being a little facetious there because it doesn't. My heart bleeds for the thousands of hardworking men and women that have been damaged permanently because of your inaction. You know, it is not a sin of commission that you are guilty of. It is a sin of omission.

My family business is in an industry that we helped self-regulate, and as the Chairman of boards in the State of Florida, I have handed down death sentences to businesses who have violated the public trust. Now, your challenges are not depressed futures volumes. Your challenges are not historically low interest rates. Your challenges are not ultracompetitive pricing models or the tremendous strain financially. Gentlemen, you represent an industry that has an integrity crisis, an integrity crisis, and you can't build a marriage, a family, a small business, a state, a country, you can build nothing of value that can withstand the long haul apart from integrity.

I am led to believe here that for 20 years this company fooled you. You are the front line. You are it to whom much is given, much is expected. I have little pity for you. I have anger for what I have heard here today.

You know, we talk about studying. Well, that is great. Studying? Do something. We talked about—one of the things that I hear—we talk about the insurance, the Securities Investor Protection Corporation, how it needs to be spread to protect the customers. We have talked about that. Well, by God, do it. Make it happen. Restore public trust. You have an integrity problem, and we as Members of Congress, we can't solve your problems. We can sit here and express anger from those that we represent that have been harmed by the inaction of this industry.

I shiver to think what else is out there. It terrifies me. And Mr. Chairman, I have to tell you, my blood is boiling because you have not earned the right—you shared here, Mr. Duffy, you talked about you caution us to move authority to the government and away from the industry. What have you done to deserve self-regulation? Your inaction is destroying lives, and it angers me, and I know that down here on the other end, APPA, I know that Mr. McElroy, you talk about the great things in Dodd-Frank. Well, let me tell you some unintended consequences as a small business owner. I will tell you, Mr. Conner, the small businesses that you represent, we can't get capital from our community banks because of Dodd-Frank. There are unintended consequences of that regulation, and so when you sit here and you talk about you support it, well, that is wonderful, but to the small businesses that represent the American economy, Dodd-Frank is killing our community banks, and you have now created the legitimacy of regulation, and it will have unintended consequences on good, hardworking men and women that are doing everything right, and my family is one of those. I have a brother that got up this morning at 3:30 to go to the log woods to haul timber to mills. More regulation? He can't work any harder. To whom much is given, much is expected. I am terribly disappointed.

And Mr. Chairman, I know I have gone over my time, but there are some things that I think need to be said.

The CHAIRMAN. The gentleman's time has expired. The chair now turns to the gentleman from California for 5 minutes, Mr. Baca.

Mr. BACA. Well, thank you very much, and I want to thank the witnesses, and I am on the other side and I appreciate the Dodd-Frank legislation because it is important that we do have accountability and we have those kind of regulations that are important for us and that we have the transparency. We also have the oversight, and if we didn't have this, that is why the abuse would be there. And so it is very important when we talk about it, it is easy to talk about not having the regulations. That is what led us to the problems that we have. We didn't have a lot of the regulations in the banking industry and Wall Street, and then we used to have a gentleman that says trust me, we are making the right kind of decisions. We didn't make the right kind of decisions. That is why we have come up with the Dodd-Frank. We have to allow it to grow and develop and hold those accountabilities to allow community banks and others to do the right thing for the American people, and unless we do that and we have those regulations in place, it is not going to happen. I just wanted to state that because my good friend from Florida indicated different. I just wanted to make sure that I presented my side that is a little bit different than him because he comes from an area that he would like to do whatever he wants. I don't believe that is the way we should be and we should have regulations in place. So thank you very much.

With that, I would like to ask a question of Mr. Roth in terms of how does—in lay terms, how does the e-confirmation process of customer segregated bank accounts work for the FCM members? And this is for Mr. Roth.

Mr. ROTH. The e-confirmation process that we began using after the first of the year basically makes the confirmation process much less paper-intensive, more efficient and really is no additional cost to the FCM at all. There is a cost that is paid by NFA to the vendor of this service. But it has really improved both efficiency and in this particular case helped uncover a fraud.

Mr. BACA. Thank you, and that is why the regulations are important and that is the reason the Dodd-Frank is there, and if we didn't have it, we wouldn't be able to detect that. And do you think that online confirmation will be an effective oversight and fraud-prevention tool? Why or why not?

Mr. ROTH. I think it is a good step but I don't think it is enough. That is why we are going to our board and asking for this direct view-only online access and then moreover building a system in which we will get daily reports from all depositories for customer segregated funds. So the e-confirm process has been a huge help, and it is a step along the way, but there are certainly bolder steps that we are taking and starting at our August board meeting and moving on from there to build the system I described in my testimony.

Mr. BACA. Thank you. Let me ask just a general question because it is a topic that we were discussing and my good friend from Florida was saying that we didn't need the regulations. Do you believe that we should have regulations and regulations should be in place whether it is the Dodd-Frank legislation or any others? Do you believe that regulations are good for us? And I open it to all of you. Or should we just allow everybody to say trust me, I am going to do the right thing? And I open it up for all of you?

Mr. ROTH. Could I go first?

Mr. BACA. Yes.

Mr. ROTH. I have been a regulator for 29 years so I may bring a little bias to this question, but obviously the whole point of regulation is based on the recognition that these markets are vital to our economy. For the markets to thrive, there has to be public confidence in the integrity of the markets, and the regulatory process is designed to ensure that integrity and foster that public confidence—so regulation is essential. The question is, how to do it right, how to do it smart and how to do it in a way that the bad guys can't win?

Mr. BACA. That is the only way that we can also restore that public trust that the gentleman from Florida said that we needed to do, but thank you.

I will open it up for the rest, any one of you that would like to address it.

Mr. LUKKEN. I will quickly address it. I am a former regulator so I am supportive, as Dan mentioned, smart regulation, making sure that it makes sense for the marketplace, that it stops this type of behavior but also proper enforcement of that regulation. I think that is where we need to concentrate. There are lots of rules to the road. Let us make sure that those are being properly enforced, and certainly some of the things that have been mentioned today, the e-confirm system, giving access to regulators, those are all great tools that will allow them to enforce these rules and make sure this is ferreted out quickly.

Mr. BACA. Thank you.

Anyone else?

Mr. MCELROY. I think we are generally supportive but if it goes so far and we do have unintended consequences, we have to be careful of that. From our industry standpoint, looking at some of the regulations that appear to potentially affect, adversely affect our customers in public power and small businesses is a little bit of a challenge given the cost-benefit, and it is an unintended consequence. On a broad scheme in terms of the regulatory regimes and issues, I couldn't agree more, couldn't agree more, but when it gets down to such a low level and unintended consequences, there needs to be a way to address that and ensure that those small folks, small businesses on Main Street don't get hurt.

Mr. BACA. Right, and those are areas that we need to work on and try to define to allow that public trust and allow that entity to grow, so all of us can agree on that.

Anybody else? If not, I know my time has expired. If not, I would like to thank the Chairman for allowing me to ask a few questions. Thank you very much.

The CHAIRMAN. The gentleman's time has expired, and the Chairman will just note that his good friends on the West Coast and East Coast always have very sincere discussions about philosophy and policy.

And with that, the gentleman from Illinois is recognized for the final set of questions for 5 minutes.

Mr. HULTGREN. Thank you, Mr. Chairman, and I do thank you all for being here. These are tough times. This is difficult. You know, it is not new that we have corrupt people who break the law, but we have to do everything we can to go after them and to be working together to make sure that this doesn't happen, that we keep the integrity in a system that is so important to the viability of our nation, of our future.

I want to just follow up on a couple questions I had for Chairman Gensler just to see if you have any thoughts on this. I had mentioned about yesterday the CFTC publishing the initial list of swaps proposed to be subject to the clearing mandate, talked about that Europe will not be prepared to have any such clearing mandate in effect until at least 2013. The Chairman talked a little bit about Asia and where they are coming in, also a different timing. So it sounds like again there are going to be different timings that these mandates will come in. I wanted to ask you what impact you expect the timing of these mandates to have since they are not coordinated.

Mr. DUFFY. I will just quickly answer. I think that any time you don't have universal coordination on markets that are global in nature, it could always be an issue. So obviously we are a bit concerned about the United States always being the leader in regulation and nobody else following because sometimes business will go along with it. I know the financial services industry has not exactly been the shining star in the room over the last several years, but I assure you, it is one of the most important things that the United States of America has going for it is the United States financial system. I would hate to see us get overregulated to a point or have rules put upon us that put us in a very—a place that is very anticompetitive, so that is really my biggest concern, sir.

Mr. HULTGREN. I am concerned of that as well. Any other thoughts that anyone has? Otherwise I have a couple other questions.

LIBOR has been a big issue obviously through this process, and given the impact that LIBOR has had on lending for mortgages and credit cards and now suspicion cast on the integrity of that rate. I wonder if there are any other benchmarks that are out there that may be more reliable from your perspective?

Mr. DUFFY. There are several benchmarks out there, sir, but you have to realize that there is $377 trillion benchmarked to LIBOR with an additional $10 trillion in loans. This is probably the largest amount of money benchmarked to any particular one asset class, and there are other rates such as Fed funds that could maybe potentially substitute. I think that many people believe that with the now-discovery of what CFTC has done with Barclays that the LIBOR process as it goes forward may become the most reliable index, not the most vaulted index.

Mr. HULTGREN. Let me stick with you, Mr. Duffy, if that is all right, just a couple more questions. I know that you testified about hundreds of millions of dollars that the CME has dedicated to SIPC trustee and you talked about the CME trust pledge. I wonder if the trustee had taken advantage of the CME guarantee. Why, if so, or why not?

Mr. DUFFY. Congressman, as everybody knows, CME Group pledged $550 million to the clients of MF Global to the trustee in order to get money back as quickly as possible. The trustee, I believe, is up to 82¢ on the dollar and working its way north of that. I don't believe the trustee has taken advantage of CME Group in any which way. I think the trustee has had the ability to move fast because of what CME did, so I don't believe it was taken advantage of. I think it was the right thing for us to do and the right thing for the clients to get.

Mr. HULTGREN. Again, Mr. Duffy, Mr. Roth, maybe if you could comment on this, and this is just a fundamental question of who has more interest in the integrity of the futures market? The exchanges or the government? I would like to hear your point of view of how important integrity is.

Mr. DUFFY. I have a real philosophical view on this since I spent my first 22 years never getting a paycheck in my life and the only way I made a paycheck is by trading. I believe that the fundamental core of the futures market is the credibility of it, and that is where I sit today as Chairman and President of the company. That is the philosophy, is the credibility, contrary to what Mr. Southerland said, and the core of this business, and we will do whatever it takes. So whether we are now a for-profit public company, if we don't have a credible business line, we don't have a credible for-profit public company, and that is the way we put it in order.

Mr. ROTH. From my point of view, Congressman, the suggestion that the fraud at Peregrine would have been uncovered more quickly if the examiners had been on the government's payroll instead of our payroll is something that I just don't think has a rational basis in fact. I think to me, the key question is less who is doing the looking than it is how are they doing the looking. That is why we immediately after MF Global started trying to incorporate as much technology as we can in this process and why we are taking the steps that I outlined in my testimony.

Mr. HULTGREN. Well, my time has expired. I appreciate again you being here. These are again very difficult times. All of us are committed to the integrity of our financial system, so I ask just to continue to work together. I know you are passionately committed to that as well as we are to make sure that that confidence is there but also to make sure that our constituents aren't hurt, our farmers, ranchers, people who are engaged in these markets aren't hurt. We want to do that.

So thanks for being here. We are going to need to continue to work together again to make sure that we solidify that integrity of the markets and continue to protect our constituents. With that, I yield back. Thank you, Mr. Chairman.

The CHAIRMAN. The gentleman's time has expired. The gentleman yields back. With that, all time has expired.

I wish to thank our panel as we dismiss them for your insights and your answers to our questions, and to note before we adjourn, I invite my acting Ranking Member, any closing comments, Mr. Acting Ranking Member?

Mr. BOSWELL. I just appreciate that we have had this today. Thank you for your work, and I am taking it from here that you are going to go out there and work harder and increase your resources to get it done.

Thank you very much, and with that, I yield back.

The CHAIRMAN. The gentleman yields back.

Under the rules of the Committee, the record of today's hearing will remain open for 10 calendar days to receive additional material and supplemental written responses from the witnesses to any questions posed by a Member.

This hearing of the Committee on Agriculture is adjourned.

[Whereupon, at 11:18 a.m., the Committee was adjourned.]

[Material submitted for inclusion in the record follows:]

SUPPLEMENTARY MATERIAL SUBMITTED BY HON. GARY GENSLER, CHAIRMAN, COMMODITY FUTURES TRADING COMMISSION

During the July 25, 2012 hearing entitled, *Oversight of the Swaps and Futures Markets: Recent Events and Impending Regulatory Reforms*, requests for information were made to Mr. Gensler. The following are his information submissions for the record.

Insert 1

Mr. COSTA. Do you anticipate being able to coordinate resources with clearinghouses? You are talking about the timelines in Japan, the timelines in Hong Kong, and the timelines for implementation in Europe with those other clearinghouses to try to provide a worldwide regulatory framework.

Mr. GENSLER. I think we are coordinating well but we have different politics and different cultures so there will be different timelines. In some countries, they might be significantly later than us but I am encouraged by Europe and Japan and Canada.

Mr. COSTA. For your discussion of those timelines, could you provide the Committee, because you talked about you are almost at the rulemaking now, what you see the timelines out for the next 2 years? Would that be possible?

Mr. GENSLER. I am sorry. Did you say for the next——

Mr. COSTA. Two years.

Mr. GENSLER. Two years? I think we can provide something to you in terms of the rules that are already finalized when there are compliance dates and then second, when we——

Mr. COSTA. Mr. Chairman, I would like that provided to the Committee so that we can all have a better understanding of that.

A core provision of title VII of the Dodd-Frank Act is the requirement that standardized swaps be centrally cleared. The Act includes an exception for non-financial end-users, with the requirement only applying to a transaction where both counterparties are subject to it.

For swaps submitted to the Commission for mandatory clearing, the Commission will review the submission and determine whether the swap, or group, category, type, or class of swaps described in the submission is required to be cleared. The Commission, generally, is to make its determination within 90 days after a complete submission. The Commission recently finalized a mandatory clearing requirement that covers specified classes of interest rate and credit default swaps.

Commission rules regarding the clearing requirement include phased compliance for different categories of market participants. Transactions involving only swap dealers will be subject to earlier compliance than those between swap-dealers and non-swap dealers. Additional time is provided before compliance is required with respect to a transaction that does not have a swap dealer as a counterparty.

U.S. timing regarding the clearing requirement broadly aligns with both Japan and Europe.

The legislature in Japan adopted legislation in May 2010 which mandates clearing of certain swaps. Japanese regulators recently published the requirement that certain index-based CDS and certain yen-denominated interest swaps to be subject to mandatory clearing. In addition, the Japanese Financial Services Agency is considering expanding its mandatory clearing coverage to include U.S. dollar- and euro-denominated interest rate swaps, as well as yen-denominated interest rate swaps referencing TIBOR.

The European Securities and Markets Authority has published its technical standards for clearing, reporting and certain risk mitigation rules for adoption by the European Commission.

The Commission continues to consult closely with fellow regulators in Australia, Hong Kong Singapore, and other jurisdictions.

In June, the Commission—consulting closely with domestic and foreign regulators—proposed guidance interpreting the cross-border application of the swaps market reforms of the Dodd-Frank Act. In a separate release, the Commission proposed phased compliance for foreign swap dealers (including overseas affiliates of U.S. swap dealers) regarding certain requirements of Dodd-Frank swaps market reform.

Such phased compliance would enable market participants to comply with the Dodd-Frank Act in an orderly fashion. It would allow time for the CFTC, international regulators and market participants to continue coordinating on regulation of cross-border swaps activity. And it would allow for appropriate implementation of substituted compliance, or allowing market participants to comply with Dodd-Frank through comparable and comprehensive foreign regulatory requirements.

The CFTC has a consistent record of relying on comparable home country regulation where appropriate. We are very much committed to recognition regimes for swaps market reforms as well, where there are comparable and comprehensive requirements.

The CFTC also has had a long history of working with international regulators to coordinate oversight of cross-border entities. We have done so with regard to clearinghouses, futures commission merchants and foreign boards of trade.

Insert 2

> Mrs. NOEM. Thank you, Mr. Chairman, and I appreciate this hearing. It is timely given it is the second anniversary of the Dodd-Frank and we need to look at these reforms and the related rules and see how they impact people on the ground. For example, in South Dakota, where I am from, some businesses and producers who are actively investing in the commodity market are still dealing with the failure of MF Global, so I just have a couple questions for you.
>
> Does the CFTC have the power to force a firm into bankruptcy?
>
> Mr. GENSLER. We might need to get back to you, but I am not aware of that. Even in this Peregrine situation, we went into court to ask for a receiver to be appointed to freeze the assets, which we do in Ponzi schemes as well. So I think that is the route. I believe the answer is no but we seek a court to appoint a receiver.
>
> Mrs. NOEM. Okay. That is the route that is generally followed? Well, if there is more information on that that you can give me later, I would appreciate that. That would be great.

The attached CFTC staff memorandum discusses the applicable laws that affect the insolvency of a futures commission merchant that is also a broker dealer.

ATTACHMENT

Memorandum

From: Robert B. Wasserman, Chief Counsel, Division of Clearing and Risk
Re: SIPA Proceedings for insolvent FCMs
Date: April 1, 2012

Introduction

The following is an analysis of the circumstances where the insolvency of a Futures Commission Merchant that is also a Broker Dealer would proceed under the Securities Investors Protection Act, 15 U.S.C. § 78aaa, *et. seq.* (SIPA) rather than as a commodity broker bankruptcy under Subchapter IV of Chapter 7 of the Bankruptcy Code, 11 U.S.C. § 761, *et. seq.* (Subchapter IV).

As discussed further below, jurisdiction under SIPA is based on the existence of at least one securities customer whose claims may be satisfied by SIPC, rather than on the predominance of securities customers *versus* commodity customers. However, as also discussed further below, the interests of commodity customers are not ignored under SIPA.

Discussion

Futures Commission Merchants ("FCMs") are the financial intermediaries for futures market transactions.[1] A bankrupt FCM which has a "customer," as that term is defined in the Bankruptcy Code, is known as a "commodity broker."[2] A commodity broker bankruptcy must proceed as a liquidation under Chapter 7 of the Bankruptcy Code, rather than a reorganization under Chapter 11, and the trustee has duties specified in Subchapter IV of Chapter 7.[3] Chief among those duties is the duty to endeavor to transfer the positions of customers of the FCM to a solvent FCM.[4] The financial intermediaries for securities are known as broker dealers ("BDs"), and the insolvency of a BD proceeds under SIPA. For the reasons that follow, the insolvency of an entity that is both a commodity broker and a BD (a "BD/FCM") will, so long as there is at least one securities customer, proceed under SIPA.

Section 5(a)(1) of SIPA[5] provides that "[i]f the [SEC] is aware of facts which lead it to believe that any broker or dealer subject to its regulation is in or is approaching financial difficulty, it shall immediately notify SIPC."

Section 5(a)(3)(A)(A) provides that SIPC may file an application for a protective decree with respect to a member with *any* (securities) customers if it determines

[1] *See generally,* Commodity Exchange Act ("CEA") §§ 1a(28), 4d, 7 U.S.C. §§ 1a(28), 6d.
[2] *See* Bankruptcy Code (hereinafter "Code") § 101(6), 11 U.S.C. § 101(6).
[3] *See* Code § 109(d), §§ 761 *et. seq.*
[4] *See* 17 CFR § 190.02(e)(1).
[5] Section 5 of SIPA is codified at 15 U.S.C. § 78eee.

that the member "has failed or is in danger of failing to meet its obligations to customers" and one of the conditions specified in § 5(b)(1) of SIPA exists.[6] Those latter conditions include (a) that the debtor is insolvent, or (b) that a proceeding is pending before any court or agency of the United States in which a receiver, trustee, or liquidator for such debtor has been appointed, or (c) that the debtor is not in compliance with the rules of the SEC or an SRO with respect to financial responsibility or hypothecation of customer securities, or (d) that the debtor is unable to make such computations as may be necessary to establish compliance with such financial responsibility or hypothecation rules.

There is no means for the CFTC to effect the placement of a BD/FCM into a Chapter 7, Subchapter IV proceeding that avoids SIPA. If the BD/FCM were to file for relief under Chapter 7 of the Bankruptcy Code, the U.S. Trustee would appoint a trustee from among the panel of persons established by the U.S. Trustee for that jurisdiction.[7] If the CFTC were to take action to appoint a receiver for an FCM with the intention that the receiver file for bankruptcy, that would, by assumption, involve the appointment of a receiver. In either case, the condition in (b) above would be established. Moreover, pursuant to § 5(a)(3)(B) of SIPA, "[n]o member of SIPC that has a customer may enter into an insolvency, receivership, or bankruptcy proceeding, under Federal or State law, without the specific consent of SIPC, except as provided in title II of the Dodd-Frank Wall Street Reform and Consumer Protection Act."

Accordingly, so long as there is at least one securities customer, the CFTC has no way to prevent SIPC from initiating a SIPA proceeding, and SIPA prevents the initiation of a Chapter 7, Subchapter IV proceeding without SIPC's specific consent.

Additionally, once SIPC initiates a SIPA proceeding, the district court is, pursuant to Section 5(b)(2)(B)(i) of SIPA, obligated to "stay any pending bankruptcy, mortgage foreclosure, equity receivership, or other proceeding to reorganize, conserve, or liquidate the debtor or its property and any other suit against any receiver, conservator, or trustee of the debtor or its property, and shall continue such stay upon appointment of a [SIPC] trustee." Thus, any Subchapter IV proceeding must be stayed by the district court in a SIPA proceeding.

Thus, the only effect that FCM or CFTC action to cause the initiation of a Subchapter IV proceeding with respect to a BD/FCM can have is to confuse and complicate the insolvency of the BD/FCM. Moreover, the succession of trustees and confusion with respect to jurisdiction is likely to delay the circumstances in which the commodity customer positions and any available associated collateral are transferred from the insolvent FCM to other FCMs.

This does not mean that the interests of commodity customers are ignored in a SIPA proceeding. Specifically, SIPA § 7(b)[8] provides that

> "To the extent consistent with the provisions of this chapter or as otherwise ordered by the court, *a trustee shall be subject to the same duties as a trustee in a case under chapter 7* of Title 11, *including, if the debtor is a commodity broker,* as defined under section 101 of such title, *the duties specified in subchapter IV of such chapter 7,* except that a trustee may, but shall have no duty to, reduce to money any securities constituting customer property or in the general estate of the debtor."

Thus, commodity customers in a SIPA proceeding do not, pursuant to SIPA, suffer any disadvantage relative to commodity customers in a Subchapter IV proceeding.

Insert 3

Mr. STUTZMAN. September 1, 2011, MF Global announces in a public filing that it would comply with FINRA's determination and increase its capital. Would such a filing trigger any red flags at CFTC?

Mr. GENSLER. As I am not participating, I don't know what the Commissioners or the agency looked at about that September 1st filing. But just as a general matter, our examination staff will work with the self-regulatory organizations like FINRA and Chicago Mercantile Exchange and NFA on any filings about capital and try to understand what those filings are.

Mr. STUTZMAN. So did that happen? Did your agency work with FINRA at all?

[6] SIPA § 5(a)(3)(A) provides that no application shall be filed by SIPC with respect to a member, the only customers of which are persons whose claims could not be satisfied by SIPC advances pursuant to Section 9 of SIPA. MFG did not fall within this exception.

[7] Code § 701(a)(1).

[8] 15 U.S.C. 78fff–1(b).

Mr. GENSLER. Again, I don't know because I haven't gone back and done the forensics. I haven't been involved since this whatever, November 2nd or 3rd period of time.

Mr. STUTZMAN. Is that something you could find out and notify——

Mr. GENSLER. Our General Counsel, Dan Berkovitz, will follow up with you.

At the end of August 2011, SEC staff contacted CFTC staff regarding MF Global's repo to maturity transactions.

On September 19, 2011, CFTC staff held a teleconference with FINRA staff to obtain further information regarding the repo to maturity transactions.

On October 25, 2011, CFTC staff spoke with FINRA staff regarding MF Global. During this call, FINRA discussed certain additional steps it had taken to monitor MF Global.

On October 27, 2011, staff in the CFTC New York Regional office was contacted by SEC staff. CFTC staff ultimately joined the SEC staff in a meeting at MF Global that was the initiation of an SEC examination of the firm.

On October 28, 2011, CFTC staff spoke with FINRA staff regarding the status of MF Global.

On October 30, 2011, CFTC and SEC staff participated in a conference call with MF Global regarding MF Global's financial status and the production of documents related to that status.

Insert 4

Mr. CONAWAY . . . Chairman, one real quick follow-up. Section 722(d) is the section you cite that gives you the authority to do the guidance on the extraterritorial or cross-border; 722(c), we think gives the SEC similar authority. What is y'all's understanding or can you help us understand your interpretation of those two different sections?

Mr. GENSLER. Section 722(c) would be in the swaps section of the statute. It may well that you want to follow up with——

Mr. CONAWAY. Okay, if you wouldn't mind getting back with us on that because——

Mr. GENSLER. Because I understood that it is all in the first part of that Title VII is swaps, which is the CFTC, and then of course the other section later in the chapter is there but 722(c), Dan? Maybe we will have to——

Mr. CONAWAY. All right. We will follow up with you on that if you wouldn't mind.

Section 722(d) of the Dodd-Frank Act relates to the CFTC's extraterritorial jurisdiction over swaps. Subtitle B of Title VI, sections 761 through 744, applies to securities-based swaps under the jurisdiction of the Securities and Exchange Commission.

SUBMITTED LETTER TO HON. GARY GENSLER, CHAIRMAN, COMMODITY FUTURES TRADING COMMISSION FROM HON. K. MICHAEL CONAWAY, A REPRESENTATIVE IN CONGRESS FROM TEXAS AND RESPONSE

August 21, 2012

Hon. GARY GENSLER,
Chairman,
Commodity Futures Trading Commission,
Washington, D.C.

Dear Chairman Gensler:

Thank you for your recent testimony before the House Committee on Agriculture hearing entitled, *Oversight of the Swaps and Futures Markets: Recent Events and Impending Regulatory Reforms.* This letter serves as a follow-up to my questions inquiring about the coordination between the Commodity Futures Trading Commission (CFTC) and the Securities and Exchange Commission (SEC) with respect to the extraterritorial application of Title VII of the Dodd-Frank Wall Street Reform and Consumer Protection Act (P.L. 111–203). As you will recall, I asked you during the hearing to clarify why the statutory language found in Section 722(d) of Title VII of the Dodd-Frank Act serves as the legal rationale for the CFTC's inability to issue a joint rule with the SEC on cross-border jurisdiction.

As a follow-up, could you please explain why Section 722(d), which governs swaps under the CFTC's jurisdiction, and Section 772(c), which governs security-based swaps under the SEC's jurisdiction, prevents the two Commissions from coordinating on a single joint rulemaking?

As you know, Section 722(d) of Dodd-Frank provides that Title VII "shall not apply to activities outside the United States" unless those activities "have a direct and significant connection with activities in, or effect on, commerce of the United States" or "contravene such rules or regulations as the Commission may prescribe or promulgate as are necessary or appropriate to prevent the evasion of any provision of this Act that was enacted by [Title VII]." Similarly, Section 772(c) of Dodd-Frank provides that "[n]o provision of [Title VII] shall apply to any person insofar as such person transacts a business in security-based swaps without the jurisdiction of the United States, unless such person transacts such business in contravention of [SEC rules]."

My plain-language reading of Sections 722(d) and 772(c) appears to be a limitation on the extraterritorial reach of both agencies, not a mandate that prohibits the CFTC from engaging with the SEC on a joint rulemaking. In fact, Sections 712(a)(1) and 712(a)(2) of Dodd-Frank both require that the CFTC and SEC "consult and coordinate . . . for the purposes of assuring regulatory consistency and comparability, to the extent possible."

Section 712(a)(7)(A) further reinforces this point by stating that the CFTC and SEC "shall treat functionally or economically similar products or entities . . . in a similar manner." As you well understand, no joint rulemaking between the CFTC and SEC on the extraterritorial regulation of swaps and security-based swaps would require that both types of contracts be treated identically by the two agencies. Rationales to provide different regulatory treatment for very specific types of contracts would certainly exist within a jointly-written rule. Indeed, Dodd-Frank Section 712(a)(7)(B) expressly provides the CFTC and SEC with the flexibility that economically similar products need not be treated in an identical manner. Read together, all of the Dodd-Frank sections referenced above seem to logically point to a thorough joint rulemaking on cross-border regulation from the CFTC and SEC.

However, I am concerned that the CFTC's proposed cross-border guidance released on June 29, 2012, is the first action which will ultimately result in swaps and security-based swaps being governed by two very different regulatory regimes. From a regulatory compliance standpoint, the most-restrictive guidance or rulemaking will likely become the *de facto* standard for the entire swaps and security-based swaps marketplace. Nevertheless, we must avoid the illogical creation of a disparate regulatory environment that would result in the same market participant being a "U.S. person" for trading in swaps while simultaneously considering them a "non-U.S. person" for trading in security-based swaps.

Finally, Section 752(a) of the Dodd-Frank Act requires the CFTC and SEC to seek harmonization on an international level by consulting and coordinating "with foreign regulatory authorities on the establishment of consistent international standards" for swaps regulation. Absent consistent regulatory standards proposed by our own domestic regulators, effective coordination between U.S. and foreign regulators would seem virtually impossible. How does the CFTC plan to coordinate with international regulators if swaps and security-based swaps are governed by two different extraterritorial regulatory regimes?

Thank you again for answering the questions above related to the creation of a consistent regulatory regime for the swaps and security-based swaps marketplace. I look forward to receiving your written response by Friday, September 7, 2012, so it can be included in the official Committee hearing record.

Sincerely,

Hon. K. MICHAEL CONAWAY,
Chairman,
Subcommittee on General Farm Commodities and Risk Management.

October 10, 2012

Hon. K. MICHAEL CONAWAY,
Chairman,
Subcommittee on General Farm Commodities and Risk Management,
House Committee on Agriculture,
Washington, D.C.

Dear Chairman Conaway:

Thank you for your letter of August 21, 2012, following up on our discussion during the Committee on Agriculture's hearing of July 25, 2012.

The Commodity Exchange Act (CEA)—as amended by the Dodd-Frank Wall Street Reform and Consumer Protection Act—directs the Commodity Futures Trading Commission (CFTC) to implement swaps market reforms, to coordinate closely with other domestic regulatory agencies, and to coordinate as well with regulators in foreign jurisdictions. In addition, in particular instances, Congress has directed the CFTC to conduct rulemakings jointly with the Securities and Exchange Commission (SEC). The two Commissions worked well and closely together to complete this year final joint rules that further define important terms.

In addition to cooperating on joint rules, the CFTC and the SEC are coordinating closely in writing other rules to implement the derivatives provisions of the Dodd-Frank Act. We coordinate and consult on each rulemaking, including sharing many of our memos, term sheets and draft work product. This close working relationship has benefited the rulemaking process, and will continue throughout completion of rulemaking and implementation. Staffs of the SEC and CFTC have jointly held a number of roundtable discussions to obtain the public's views.

This process of consultation and coordination has been followed with regard to considerations of the cross-border application of Dodd-Frank. On August 1, 2011, staffs of the two Commissions hosted a roundtable discussion on international issues relating to the implementation of title VII of the Dodd-Frank Act. This meeting as well as public comments and other meetings have facilitated the agencies' understanding of related issues as well as helped us to share a common understanding with regard to the important matters to be addressed by both Commissions in our joint and separate rulemakings.

Section 722(d) of the Dodd-Frank Act states that swaps market reforms under the CEA shall not apply to activities outside the United States unless those activities have "a direct and significant connection with activities in, or effect on, commerce of the United States." The Commission has received requests from market participants seeking the agency's interpretation of swap market reforms in light of that provision.

In June, the Commission—consulting closely with domestic and foreign regulators—proposed guidance interpreting the cross-border application of the Dodd-Frank Act. In a separate release, the Commission proposed phased compliance for foreign swap dealers (including overseas affiliates of U.S. swap dealers) regarding certain requirements of Dodd-Frank swaps market reform.

Such phased compliance would enable market participants to comply with the Dodd-Frank Act in an orderly fashion. It would allow time for the CFTC, international regulators and market participants to continue coordinating on regulation of cross-border swaps activity. And it would allow for appropriate implementation of substituted compliance, or allowing market participants to comply with Dodd-Frank through comparable and comprehensive foreign regulatory requirements.

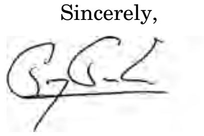
The CFTC has a consistent record of relying on comparable home country regulation where appropriate. We are very much committed to recognition regimes for swaps market reforms as well, where there are comparable and comprehensive requirements.

The CFTC also has had a long history of working with international regulators to coordinate oversight of cross-border entities. We have done so with regard to clearinghouses, futures commission merchants and foreign boards of trade. The Commission has sought public comment regarding these releases and the Commission staff is closely reviewing that input in preparation for final action.

As the process of swaps market reform implementation proceeds, the Commission will continue to work closely with the SEC and other domestic regulators. The Commission is also working closely with regulators in foreign jurisdictions—often sharing memos, term sheets and draft work product as we do with other domestic agencies. These efforts are designed to assure regulatory consistency and comparability to the extent possible, taking into consideration differences in markets and in the applicable statutory requirements.

Thank you for your letter and for your support of the work of the CFTC. If I can be of further assistance, please do not hesitate to let me know.

Sincerely,



Hon. GARY GENSLER,
Chairman,
Commodity Futures Trading Commission.

SUBMITTED QUESTIONS

Response from Hon. Gary Gensler, Chairman, Commodity Futures Trading Commission

Questions Submitted by Hon. Frank D. Lucas, a Representative in Congress from Oklahoma

Question 1. Chairman Gensler, I received the following questions on August 2, 2012, in a letter from the following members of the Florida Congressional delegation: Representatives Stearns, Posey, Mica, Nugent, Ross, West, Rivera, Buchanan, Ros-Lehtinen, Young, and Miller:

How has the [LIBOR] manipulation affected the housing market in Florida?

Question 2. With such a large population of older Americans in Florida, have our constituents' retirement savings been disproportionately affected compared to the rest of the country?

Question 3. How has the LIBOR manipulation affected private student loan interest rates, which according to the Consumer Financial Protection Bureau, has surpassed credit card debt as the biggest source of unsecured debt for U.S. consumers?

Answer 1–3. The Commission does not have data on the on the Florida housing market or on private student loans, nor did the Commission's order find the effect of Barclays actions on LIBOR. The Commission's order stated that Barclays repeatedly attempted to manipulate and made false, misleading or knowingly inaccurate submissions concerning LIBOR.

Question 4. What work is the CFTC doing to aid the Department of Justice in civilly and criminally charging those involved?

Answer. The Commission's Division of Enforcement referred the Barclays matter to the Department of Justice. That referral culminated in an agreement with the Fraud Section of the U.S. Justice Department's Criminal Division, in which Barclays agreed to pay a $160 million penalty and to continue to cooperate with the Department.

Question 5. How does the CFTC plan to help state governments assess the impact the LIBOR fraud has had on them as individual states?

Answer. In appropriate circumstances and with appropriate confidentiality agreements in place, we can and often do share information with state law enforcement authorities. In fact, the Commission's Office of Cooperative Enforcement, a unit of the Division of Enforcement, has the goal of ensuring that enforcement of the commodity futures laws is addressed through civil, criminal, or administrative actions by state and Federal agencies or branches of government whenever possible.

Question Submitted by Hon. K. Michael Conaway, a Representative in Congress from Texas

Question. Chairman Gensler, do you have any reason to believe the CFTC would have uncovered this fraud sooner had it been tasked with the audit of Peregrine instead of the NFA? If the CFTC had the sole authority to audit market participants, what would you and your staff have done differently?

Answer. The regulatory system did not adequately protect Peregrine's customers. More needs to be done to protect customers. The Commission is proceeding to consider staff recommended proposed rules that incorporate three key reforms recently adopted by the NFA and would require:

- FCMs to hold sufficient funds in Part 30 secured accounts (funds held for U.S. foreign futures and options customers trading on foreign contract markets) to meet their total obligations to customers trading on foreign markets computed under the net liquidating equity method. FCMs would no longer be allowed to use the alternative method, which had allowed them to hold a lower amount of funds representing the margin on their foreign futures;
- FCMs to maintain written policies and procedures governing the maintenance of excess funds in customer segregated and Part 30 secured accounts. Withdrawals of 25 percent or more would necessitate pre-approval in writing by senior management and must be reported to the designated SRO and the CFTC; and
- FCMs to make additional reports available to the SRO and the CFTC, including daily computations of segregated and Part 30 secured amounts.

Additional reforms in the staff recommendations include requiring that SROs and the CFTC have direct electronic access to FCMs' bank and custodial accounts for customer funds, that acknowledgement letters and confirmation letters come directly to regulators from banks and custodians, enhanced risk disclosures to customers, setting standards for the SROs' examinations and the annual certified financial statement audits, including raising minimum standards for independent public accountants who audit FCMs and implementing a more effective early warning system for the Commission and the SROs that alert them to material events.

If the Commission approves the staff recommendations, further public comment will be of great value to the agency in devising final rules that best ensure the protection of customer funds.

Regarding the Commission's oversight of SROs and intermediaries, though we're making progress through our reorganization at the CFTC and new rules, the recent events at Peregrine highlight the necessity of looking at the decades-old system of SROs and the Commission's role in overseeing SROs.

I have directed the CFTC's staff to do a full review of how the agency conducts oversight of the SROs, as well as limited scope reviews of FCMs, to determine what improvements can and should be made. As part of this review, we have reached out to the Public Company Accounting Oversight Board (PCAOB), which oversees the audits of public companies. The Dodd-Frank Act gave the PCAOB oversight authority over the audits of brokers and dealers who are registered with the Securities Exchange Commission. The PCAOB has agreed to give us the benefit of its insights and expertise.

Questions Submitted by Hon. Scott R. Tipton, a Representative in Congress from Colorado

Question 1. The FCS is a government sponsored enterprise (GSE) that is made up of 4 Federal Farm Credit Banks and approximately 80 lending associations. All System entities are jointly and severally liable for the actions of each other component of the System—in other words, the actions of one FCS lender ultimately will impact the entire System. Congress designed it that way. With this system of interlocking liability in mind, the FCS could be considered a $231 Billion financial services institution. Did the Chairman consider this fact when he issued the "Clearing Exemption for Certain Swaps Entered into by Cooperatives"?

Question 2. The central idea advanced by the CFTC in the recently proposed "Clearing Exemption for Certain Swaps Entered into by Cooperatives" is that the FCS banks lend to the FCS associations, which lend to farmers, and farmers own the FCS associations, which own the FCS banks—principally that the Farm Credit System is a cooperative. CFTC then proposes that "cooperatives meeting certain conditions are the class of persons that should be exempted from the clearing requirement for certain types of swaps. cooperatives act on behalf of their members in certain financial matters. The proposed rule provides for passing through the end user exemption available to such cooperative's members." I find your logic lacking here. Why does who owns an entity make any difference in the regulation of the derivatives market?

Question 3. You observe in the proposed rule: "cooperatives have a member ownership structure in which the cooperatives exist to serve their member owners and not act for their own profit. In a real sense the cooperative is not separable from its member owners." What is unique about the ownership structure of cooperatives that would prevent a large financial institution like the Farm Credit System from making stupid, imprudent, wrong, or costly mistakes? Haven't you have been charged to regulate the derivatives market to protect the financial system from stupid, imprudent, wrong and costly mistakes? Doesn't exempting a financial cooperative with assets of more than $230 billion from certain derivatives activities expose the entire financial system to unintelligent, imprudent, wrong or costly mistakes?

Answer 1–3. The comment period for the CFTC's proposed rule on a "Clearing Exemption for Certain Swaps Entered into by Cooperatives" ended on August 16, 2012. In response to this proposal, the CFTC received comment letters from market participants and interested members of the public. The Commission is reviewing these letters and evaluating the various issues raised by commenters. The CFTC will consider the issues surrounding the proposed exemption for certain cooperative swaps and cooperative structure.

Question Submitted by Hon. Mike McIntyre, a Representative in Congress from North Carolina

Question. Chairman Gensler, in the proposed rule on Product Definitions you asked a number of questions of the electric industry, and I understand that the electric utilities responded and answered the staff's questions. As you know, the Products Definitions final rule subjected the capacity and transmission contract language to further comment. It is my understanding that these transactions—capacity contracts, transmission contracts and tolling agreements—are forwards or forwards with embedded options, and not swaps. I believe it was not the intent of Congress to consider such transactions swaps under the Dodd-Frank Act. Would you please clarify the CFTC's need for further comment on capacity and transmission contracts (used to ensure delivery of electric power to utilities and their consumers) in the Products Definition final rule?

Answer. Under the Commission's final Product Definition rule, depending on the relevant facts and circumstances involved, capacity contracts, transmission contracts, and tolling agreements may qualify as forwards. The Commission issued interpretive guidance in this regard for market participants.

The Commission also believed that it would benefit from further input about that guidance and requested public comment by Oct. 12, 2012. Once this comment period has closed, the Commission will analyze the issues raised by the commenters.

SUBMITTED MATERIAL BY HON. STEVE SOUTHERLAND II, A REPRESENTATIVE IN CONGRESS FROM FLORIDA

Customer Account Agreement

PFG BEST

The BEST thing about our technology is our people.

Index of Documents

THIS AGREEMENT IS A LEGAL CONTRACT, PLEASE READ IT CAREFULLY.

This is a legal contract by and between Peregrine Financial Group, Inc., its successors and assigns, referred to collectively in this document as "PFGBEST", and the party (or parties) executing this document, referred to collectively as "Customer".

In consideration of PFGBEST agreeing to carry one or more accounts of Customer and providing services to Customer in connection with the purchase and sale of cash commodities (including financial instruments), commodity futures contracts, securities futures products, options on cash commodities, options on futures contracts, forward or leverage contracts, forward rate transactions, commodity swaps, foreign exchange transactions, currency swap transactions, cross-currency rate swap transactions, currency options, and other derivatives of futures and/or foreign currency contracts, and any similar instruments which may be purchased or sold by or through PFGBEST for Customer's Account(s) (collectively referred to as "Commodities" or "Futures"), Customer agrees to the following terms and conditions:

1. AUTHORIZATION TO TRADE.

PFGBEST is authorized to purchase and sell cash commodities (including financial instruments), commodities futures contracts, security futures products, options on cash commodities, options on commodity futures contracts, forward or leverage contracts, forward rate transactions, commodity swaps, foreign exchange transactions, currency swap transactions, cross-currency rate swap transactions, currency options, and other derivatives of futures and/or foreign currency contracts for Customer's Account(s) in accordance with Customer's oral, written or electronically transmitted instructions. Unless instructed by Customer to the contrary in writing, PFGBEST is authorized to execute all futures and option orders on such recognized contract markets, as PFGBEST deems appropriate. Customer authorizes PFGBEST to purchase and sell physically settled and cash settled foreign currency contracts on a spot basis for Customer's Account in accordance with Customer's instructions. Customer agrees that Customer is fully responsible for making all final decisions as to transactions effected for Customer's Account. Customer has considered the factors contained below and in view of Customer's present and anticipated financial resources, Customer is willing and able to assume the substantial financial risks of trading in the above markets.

2. TRANSACTIONS SUBJECT TO INDUSTRY REGULATIONS AND STANDARDS.

All transactions shall be subject to the regulations of all applicable government authorities and self-regulatory agencies including, but not limited to, the constitutions and rules of the clearinghouse, exchange, or market where trades are executed. Customer understands that PFGBEST is obligated to comply with all applicable laws and regulations including those of regulatory and self-regulatory organizations and agrees that PFGBEST shall not be liable to Customer as a result of any action taken by PFGBEST to comply with any ruling, interpretation or directive of such organization. The Customer recognizes that rates and/or prices it may view on electronic market information screens (e.g. Reuters, Flash Quotes, Telerate, etc.) are only indications of rates and/or prices, and may or may not reflect actual rates and/or prices available to PFGBEST or the Customer.

In all transactions under this Agreement, Customer shall be bound by all applicable laws, rules and regulations, including the Commodity Exchange Act, as amended, the Commodity Futures Trading Commission regulations thereunder, and the rules, regulations, customs, usages, rulings and interpretations of the National Futures Association ("NFA"), and to the extent applicable, the Securities and Exchange Commission, National Association of Securities Dealers, and the exchange or market and the clearing house, if any, where the transactions are executed by PFGBEST or PFGBEST's agents.

3. MARGINS/DEPOSIT REQUIREMENTS.

PFGBEST's margin policies and/or the policies of those exchanges on which trading occurs may require that additional funds be provided to properly margin Customer's Account. Customer understands that Customer is obligated to promptly meet such margin requirements. Failure to meet margin calls may result in the liquidation of any open positions with a resultant loss.

As security for Customer's obligation to PFGBEST hereunder, Customer shall provide to and maintain with PFGBEST margin and/or collateral in such amounts and in such forms as PFGBEST, in its sole and absolute discretion, may from time to time require. Margin requirements may be increased at PFGBEST's sole and absolute discretion. Such margin requirements may exceed margins established by an exchange. PFGBEST may change margin requirements at any time. Margin requirements are subject to change without notice and will be enforced retroactively and prospectively. Customer acknowledges and agrees that PFGBEST has no obligation to establish uniform margin requirements and that such requirements may be higher for single stock futures and other security futures products. No previous margin requirement by PFGBEST shall preclude PFGBEST from increasing that requirement without prior notice. Further, PFGBEST will exercise considerable discretion in setting and collecting margin associated with foreign currency transactions. For margin purposes associated with foreign currency transactions, Customer has authorized PFGBEST to convert Customer's funds into and from such foreign currency at a rate of exchange determined by PFGBEST, in its sole discretion, on the basis of the then prevailing money market rates.

Customer agrees to deposit by immediate wire transfer such additional margin when and as required by PFGBEST, and will promptly meet all margin calls in such mode of transmission, as PFGBEST shall in its sole discretion designate. Customer agrees to provide PFGBEST with the names of bank officers and information necessary for immediate verification of wire transfers. Notwithstanding any demand for additional margin, PFGBEST may at any time proceed to liquidate Customer's Account in accordance with paragraph 10 below. Any failure by PFGBEST to enforce its rights hereunder shall not be deemed a waiver by PFGBEST to enforce its rights thereafter.

4. LIMIT OF POSITIONS.

Exchanges where trading occurs may impose daily trading limits with respect to the trading of certain commodities and may, from time to time, change such trading limits. Such trading limits and limit changes may cause trading in a certain commodity to cease, thereby preventing the liquidation of an adverse position, which may result in a substantial financial loss. Trading in commodity futures is suitable only for those persons or entities financially able to withstand losses that may substantially exceed the value of margins or deposits. Customer acknowledges Customer's reporting obligations, among others, pursuant to regulations promulgated by the Commodity Futures Trading Commission ("CFTC"), such as Customer's obligation to notify the CFTC when Customer's position is reportable.

PFGBEST retains the right to limit the number of open positions a Customer may acquire or maintain at PFGBEST and/or the size of transaction a Customer may execute through PFGBEST. PFGBEST will attempt to execute all orders that PFGBEST may, in PFGBEST's sole discretion, choose to accept for the purchase or sale of contracts or other property in accordance with the oral or written instructions of Customer. PFGBEST reserves the right to refuse to accept any order. Notwithstanding the foregoing, PFGBEST shall not be responsible for any loss or damage caused, directly or indirectly, by any events, actions or omissions beyond PFGBEST's control, including any delays or inaccuracies in the transmission of orders and/or information due to a breakdown in or failure of any transmission or communication facilities.

5. COMMODITY OPTIONS TRADING.

With respect to purchases or sales of options on cash commodities or futures contracts ("Commodity Options"), Customer acknowledges and understands the risks of buying and selling options on commodity futures contracts and the risks of such option trading caused by a limit move in the underlying commodity futures contract. Customer has been advised of the commissions and fees associated with trading options.

Customer is fully responsible for taking action to exercise an option contract. PFGBEST shall not be required to take any action with respect to an option contract, including any action to exercise a valuable option prior to its expiration date, except upon express instructions from Customer. Customer agrees to instruct PFGBEST as to the exercise and disposition of Commodity Options. Customer understands that the exchanges, boards of trade, markets and clearinghouses have established exercise cut-off times for the tender of exercise instructions and that Customer's options will become worthless in the event that Customer does not deliver instructions by PFGBEST's established expiration times. Customer understands that PFGBEST has established exercise cut-off times, which may be different from the times established by the exchanges, boards of trade, markets, and clearinghouses.

Customer shall give PFGBEST instructions for exercising Commodity Options not later than two hours prior to the close of trading in the underlying commodity or futures contract on the day Customer intends to exercise a Commodity Option. Customer, by noon of the business day before the last day of trading of a Commodity Option, shall instruct PFGBEST whether to liquidate, exercise, or abandon the Commodity Option. In the absence of timely instructions from Customer, PFGBEST is authorized, at PFGBEST's absolute discretion, to exercise or liquidate all or any portion of the Commodity Options in Customer's Account(s) for Customer's Account(s) and at Customer's risk.

Customer hereby agrees to waive any and all claims for damage or loss that Customer might have against PFGBEST arising out of the fact that an option was not exercised.

6. ONLINE ORDER ENTRY SYSTEM.

PFGBEST offers the service of an online order entry system, which allows Customer to trade with PFGBEST online via the Internet utilizing BESTDirect™, a division of PFGBEST, as well as all other approved online order entry systems. Although numerous features have been designed into BESTDirect™ and the other approved systems to prevent system failure, as with all electronic systems, service could be interrupted. Should the system be interrupted, depending on the type of failure, it may not be possible for Customer to access the system to enter new orders, modify existing orders, or cancel previously entered but not yet filled orders. System or component failure may also result in loss of orders or order priority.

PFGBEST does not guarantee that any order placed through this system will be filled or acted on. PFGBEST reserves the right to refuse any order for any reason. Customer is solely responsible for confirming Customer's own orders. Should Customer fail to receive electronic confirmation as to the placement of an order, Customer agrees to verify the status of such order independently by contacting PFGBEST telephonically to confirm whether such order has been received. Any order so received by PFGBEST will be deemed to have been placed by Customer at the time received by PFGBEST and in the form PFGBEST receives such order. Customer further agrees that all orders placed through an online order entry system are placed at Customer's sole risk.

(a) Minimum Equity Requirement. Customer acknowledges that should the equity in Customer's Account fall below $500, Customer's access to place trades through BESTDirect™ will be suspended until such time as the equity in Customer's Account shall again equal or exceed $500.

(b) Access Number. Customer agrees to be responsible for all orders entered through and under Customer's access number(s) and account number(s). Customer agrees to immediately notify PFGBEST in the event of any loss, theft, or unauthorized use of Customer's access number(s), password(s), and/or account number(s) or any incorrect information contained in any report Customer received concerning Customer's Account.

(c) Restricted Account. PFGBEST reserves, in its sole discretion, the right to restrict, terminate and/or suspend Customer's access to an online order entry system. Customer acknowledges that if PFGBEST places a restriction on Customer's Account, Customer will not be able to use a system's online trading function. Customer agrees to hold PFGBEST harmless for any and all claims, losses, liability, costs and expenses (including but not limited to attorney's fees) arising from PFGBEST's restriction of Customer's access to an online order entry system. PFGBEST reserves, in its sole discretion, the right to terminate Customer's access to an online order entry system without notice for any reason, including but not limited to unauthorized use of Customer's access number(s), and/or account number(s), or breach of this Agreement.

7. CURRENCY FOREX TRADING.

Foreign currency transactions (hereinafter referred to as "Currency Forex") are traded on the "interbank" system, and not on regulated exchanges like commodities. The interbank system consists of counterparties that exchange currency positions with each other. A counterparty may be, but need not be, a bank. For purposes of Currency Forex trading, Daily Cutoff shall mean the time selected each Business Day by PFGBEST after which any Transaction entered into will be considered to have as its trade date the next Business Day. The Daily Cutoff will occur at a time selected solely by PFGBEST and may vary from day to day. Business Day shall mean, with respect to the United States, any day on which banks are open for business (other than a Saturday or Sunday) in New York City, and with respect to any other country other than the United States, any day on which banks are open for business (other than a Saturday or Sunday) in the principal financial center of the relevant country.

(a) Capacity. PFGBEST shall act as a principal and is the counterparty in each Currency Forex contract or transaction with Customer. Customer acknowledges, understands and agrees that PFGBEST is not acting as a broker, intermediary, agent, advisor or in any fiduciary capacity to Customer in Currency Forex transactions.

(b) Prices and Valuations for Currency Forex. Prices and valuations for Currency Forex are set by PFGBEST and may be different from prices reported elsewhere. PFGBEST will provide prices to be used in trading, valuations of Customer positions and determination of margin requirements. Although PFGBEST expects that these prices will be reasonably related to prices available in the interbank market, prices reported by PFGBEST may vary from prices available to banks and other counterparties in what is known as the interbank market.

(c) Settlement Date and Rollovers. With respect to purchases or sales of foreign currencies, Customer agrees to instruct PFGBEST as to the offset or rollover of a foreign currency position. Except as provided herein, during the term of the Currency Forex position, Customer shall give PFGBEST instructions for rolling the Currency Forex position not later than two hours prior to the settlement of trading in the relevant foreign currency on the day Customer intends to roll over that foreign currency position. In addition, Customer, by noon of the business day before the settlement day of the contract of the Currency Forex contract, shall instruct PFGBEST whether to deliver, offset or roll over the Currency Forex position. In the absence of timely instructions from Customer, PFGBEST is authorized, at PFGBEST's sole and absolute discretion, to deliver, roll over or offset all or any portion of the Currency Forex positions in the Customer's Account and at Customer's risk. Customer shall be charged separate commissions, at PFGBEST's commission rates in effect from time to time, upon the rollover or offset of a Currency Forex position.

(d) Settlement Date Offset Instructions. Offset instructions on open Currency Forex positions must be given to PFGBEST at least one (1) business day prior to the settlement or value day. Alternatively, sufficient funds to take delivery or the necessary delivery documents to make delivery must be in the possession of PFGBEST within the time frame set forth above. If no instructions, funds or documents are received by PFGBEST, then PFGBEST may, without additional notice to Customer and in PFGBEST's sole discretion, take one or a combination of the following actions: offset Customer's position, roll Customer's positions into the next settlement time period, make or receive delivery on behalf of Customer upon such terms and by such methods deemed reasonable by PFGBEST in its sole discretion.

(e) Delivery. Delivery of foreign currency shall be made to the bank specified by the purchaser in a major city in the country in which the foreign currency is the legal tender. Unless otherwise agreed to by PFGBEST and the Customer in writing, the foreign currency shall be deliverable by cable or wire transfer. All payments to be made in U.S. Dollars shall be made by wire transfer of immediately available funds to a bank in a major U.S. city specified by the purchaser. PFGBEST will not be responsible for delays or failures in the delivery of any foreign currency within the time specified for the delivery thereof to the extent the failure is caused by a breakdown of communication facilities or by any other cause beyond PFGBEST's reasonable control. PFGBEST may require payment of amounts due to PFGBEST from Customer on any day to occur simultaneously with or prior to payment of amounts due from PFGBEST to Customer on that day. PFGBEST and the Customer shall exchange, make use of, and periodically update and confirm standing payment instructions.

(f) Offsetting Transactions. Whenever there may exist in or between any of the Customer's Accounts two or more open and opposite transactions, PFGBEST may, in its sole discretion, elect to treat the transactions as a single transaction and upon the value date of the transactions, the net difference between the amounts payable under the transactions, and/or the net difference between the amounts deliverable thereunder, shall be paid to and/or delivered by PFGBEST, as the case may be.

(g) Separate Transactions. Each Currency Forex transaction is a seperate transaction, even though more than one such transaction may be included on a single confirmation.

8. COLLATERAL.

All funds, securities, commodities, commodity futures contracts, commodity option contracts, and other property of Customer which PFGBEST or its affiliates may at any time be carrying for Customer (either individually, jointly with others, or as a guarantor of the account of any other person), or which may at any time be in PFGBEST's possession, control, or carried on PFGBEST's books for any purpose, including safekeeping, are to be held by PFGBEST as security and subject to a general lien and right of setoff against liabilities of Customer to PFGBEST whether or not PFGBEST has made advances in connection with such securities, commodities or other property, and irrespective of the number of accounts Customer may have with PFGBEST. At any time, PFGBEST may in its discretion, with or without notice to Customer, apply and/or transfer any or all funds or other property of Customer between any of Customer's Accounts. Additionally, Customer hereby grants to PFGBEST the right to pledge, repledge, hypothecate, sell or purchase, invest or loan, either separately or with the property of other Customers, to itself as broker or to others, as securities or other property of Customer held by PFGBEST as margin or security. The value of any such collateral shall be determined by PFGBEST in its sole discretion and based upon what PFGBEST would receive if PFGBEST sold the relevant collateral for immediate delivery. PFGBEST shall at no time be required to deliver to Customer the identical property delivered to or purchased by PFGBEST for any account of Customer. The Customer agrees to maintain at all times with PFGBEST collateral in such form and in such amount as PFGBEST may from time to time request orally or in writing. In all cases, collateral shall be deemed received by PFGBEST when such collateral is actually received by PFGBEST. The rights of PFGBEST are subject to the applicable requirements for the segregation of Customer funds and property under the Commodity Exchange Act, as amended (the "Act").

9. LENDING AGREEMENT.

The purpose of the Lending Agreement is to allow PFGBEST to use warehouse receipts (representing delivery) as collateral. Should Customer take delivery of commodities through futures contracts, PFGBEST is obliged to make full payment for the delivery on 24 hours notice. If the balance in the Customer's Account is not adequate to pay for the delivery, the warehouse receipts become property carried on margin in the Customer's Account, since the commodity is not fully paid for by Customer. The Lending Agreement allows PFGBEST to use the warehouse receipt as collateral for a bank loan, the proceeds of which are used to pay for the warehouse receipts until redelivery of the commodity and/or payment in full by Customer. Should Customer intend to take delivery of the underlying commodity covered by any futures contract, PFGBEST requires the Customer to sign the Lending Agreement so it may use the commodities, property, warehouse receipts or evidence of ownership thereof, as collateral for a bank loan, the proceeds of which may be used to pay for the commodities, or evidence of ownership thereof, until payment in full, including interest, is made by Customer. This authorization shall apply to all accounts carried by PFGBEST for Customer and shall remain in full force until all accounts are fully paid for by Customer or until notice of revocation is sent by PFGBEST from PFGBEST's principal place of business.

10. LIQUIDATION OF ACCOUNTS.

In the event of (a) the death or judicial declaration of incompetence of Customer; (b) the filing of a petition in bankruptcy, a petition for the appointment of a receiver, or the institution of any insolvency or similar proceeding by or against Customer; (c) the filing of an attachment against any of Customer's

Accounts carried by PFGBEST; (d) Customer's failure to maintain sufficient margin; or (e) PFGBEST's determination, regardless of current market quotations, that any collateral deposited to protect one or more accounts of Customer is inadequate to secure the account; (f) Customer's failure to provide PFGBEST any information requested pursuant to this Agreement; (g) Customer's failure to pay any amount due to PFGBEST; or (h) any other circumstances or developments that PFGBEST deems appropriate for its protection, PFGBEST, in its sole discretion, may take one or more, or any portion of the following actions: (1) satisfy any obligation Customer may have to PFGBEST either directly or by way of guaranty or suretyship out of any of Customer's funds or property in PFGBEST's custody or control; (2) liquidate Customer's positions by offsetting any or all commodity futures contracts, futures options, commodities, securities, or securities options held or carried for Customer; and/or (3) cancel any or all outstanding orders or contracts, or any other commitments made on behalf of Customer. Any of the above actions may be taken without demand for margin or additional margin, without prior notice of sale or purchase or other notice to Customer, Customer's personal representatives, heirs, executors, administrators, trustees, legatees, or assigns, and regardless of whether the ownership interest shall be solely Customer's or held jointly with others. In liquidation of Customer's positions, PFGBEST may, in its sole discretion, offset in the same contract month or it may initiate new long or short positions in order to establish a spread or straddle which in PFGBEST's sole judgment may be advisable to protect or reduce existing positions in Customer's Account. According to PFGBEST's sole judgment and discretion, any sales or purchases hereunder may be made on any exchange or other markets where such business is then usually transacted or at a public auction or private sale, and PFGBEST may purchase the whole or any part thereof free from any right of redemption.

11. PAYMENT OF DEFICIT BALANCES.

Customer recognizes that PFGBEST is financially liable to the clearing members through which PFGBEST clears transactions for deficit balances occurring in Customer's Accounts. Customer therefore agrees that Customer shall at all times be liable for the payment of any deficit balance occurring in Customer's Account including any deficiency balance remaining in Customer's Account(s) in the event of the liquidation thereof in whole or in part by PFGBEST or by Customer. Customer agrees to hold PFGBEST harmless, and indemnify and defend PFGBEST from and against any and all losses sustained by PFGBEST resulting from any deficit balances that may occur in Customer's Account. In the event the proceeds realized from liquidation of Customer's Account are insufficient for the payment of all liabilities of Customer due to PFGBEST, Customer shall promptly pay upon demand, the deficit and all unpaid liabilities, together with interest thereon equal to three (3) percentage points above the then prevailing prime rate at PFGBEST's principal bank or the maximum interest rate allowed by law, whichever is lower, and all costs of collection, including attorney's fees, witness fees, travel expenses and the like. In the event PFGBEST incurs expenses other than for the collection of deficits, with respect to any of the account(s) of Customer, Customer also agrees to pay such expenses.

12. DELIVERY MONTH LIQUIDATION INSTRUCTIONS.

Liquidation instructions on open futures positions maturing in a current futures month must be given to PFGBEST at least five (5) business days prior to the first notice day in the case of long positions, and at least seven (7) business days prior to the last trading day in the case of short positions. Alternatively, sufficient funds to take delivery or the necessary delivery documents must be in PFGBEST's possession within the same periods described above. If instructions, funds or documents are not received, PFGBEST may, without notice to Customer, either liquidate Customer's position or make delivery or receive delivery on Customer's behalf on such terms, conditions and by such methods as PFGBEST deems reasonable, in its sole discretion, and Customer agrees to remain liable for all costs, expenses or debit balances incurred in connection therewith.

13. CHARGES.

Customer agrees to pay such commission rates as PFGBEST may from time to time charge, as well as all other costs and fees (including, without limitations, fees imposed by the National Futures Association, exchanges or other regulatory or self-regulatory organizations) arising out of PFGBEST's provision of services hereunder. PFGBEST may change its commissions, charges, and/or fees without notice. Customer agrees to pay all such charges as they are incurred. Customer hereby authorizes PFGBEST to withdraw the amount of any such charges from Customer's Account(s). In the event Customer instructs PFGBEST to transfer open positions, monies, and/or property from Customer's Account to another futures commission merchant, Customer agrees to pay a transfer fee, to be designated by PFGBEST.

Customer specifically agrees that, after any Account subject to this Agreement has been dormant for a period of three calendar months, as defined by the unclaimed property laws and regulations of the relevant jurisdiction(s) to which such Account is subject, such Account shall thereafter be subject to a monthly administration fee for each subsequent month during which such dormancy continues without interruption. Such monthly administration fee shall be equal to 1.75% of the liquidation value of such Account (rounded up to the nearest multiple of $10.00) or the maximum amount permitted by applicable law, whichever is less. Except as required by law, Customer shall not be entitled to a refund of any such monthly administration fee for any reason.

14. STATEMENTS AND CONFIRMATIONS.

Customer understands that Customer must carefully review the reports relating to Customer's trading sent by PFGBEST. Customer must review and report immediately errors on confirmations and statements. Failure to notify PFGBEST immediately of any error or omission will bind Customer to the terms of such confirmation or statement, as the case may be. All reports of execution shall be deemed final within twenty-four (24) hours and all statements of account will be deemed final within three (3) days, unless Customer objects to these reports within these periods of time to an executive officer of PFGBEST at PFGBEST's principal place of business.

Margin calls shall be conclusive and binding unless objected to immediately by telephone or by wire. Written objections on Customer's part shall be directed to PFGBEST's Compliance Department at 311 W. Monroe St., Suite 1300, Chicago, IL 60606 and shall be deemed received only if actually delivered or mailed by registered mail, return receipt requested. Customer's failure to receive a trade confirmation or statement of accounts shall not relieve Customer of the obligation to object as set out herein. Failure to object to statements and confirmation shall be deemed ratification of all actions taken by PFGBEST or PFGBEST's agents.

Unless Customer indicated otherwise in Item 19 of the Account Application, Customer hereby authorizes PFGBEST to deliver electronically correspondence and other communications including, but not limited to trade confirmations, daily statements, monthly statements, margin and maintenance calls, and other documents required to be delivered in connection with Customer's account. Customer agrees that the sending by PFGBEST of an e-mail to the e-mail address of record shall constitute good and effective delivery to Customer of the communication whether or not Customer actually access the communication. Customer may revoke his consent to electronic delivery of documents at any time upon written notice to PFGBEST. It is the customer's responsibility and obligation to notify PFGBEST of any change of mailing and/or electronic addresses.

Customer agrees that written statements shall supersede all electronic information and the written statements shall be controlling.

15. COMMUNICATIONS.

Reports, statements, notices and any other communications may be transmitted to Customer at the address given above or to such other address as Customer may from time to time designate in writing to PFGBEST. All communications so sent, whether by mail, telegraph, messenger or otherwise, shall be deemed transmitted by PFGBEST when deposited in the United States mail, or when received by a transmitting agent, and deemed delivered to Customer personally, whether actually received by Customer or not.

PFGBEST will not be responsible for delays in transmission of orders due to breakdown, excessive call volume or failure of transmission or communication systems or facilities, or for any other cause or causes beyond PFGBEST's reasonable control or anticipation.

16. DISCLAIMER OF WARRANTIES.

Neither PFGBEST nor its agents make any representations or warranties to Customer, express or implied, with respect to the electronic order system, or the transmission, timeliness, accuracy or completeness thereof, including, without limitation, any implied warranties or any warranties of merchantability, quality or fitness for a particular purpose, and those arising by statute or other wise in law or from any course of dealing or usage.

17. LIMITATION OF LIABILITY.

Customer agrees that in no event will PFGBEST be liable to Customer for the accuracy, interruption, delay, completeness, timeliness, or correct sequencing of the information received through Customer's use of BESTDirect™ or for any interruption of any data, information, or accessibility to BESTDirect™. Further, PFGBEST shall not be held responsible for any delay or failure to provide BESTDirect™ service, including the execution of any order. Under no circumstances shall PFGBEST or its agents be liable for any indirect, incidental, special or consequential loss or damages, including loss of business or profits or goodwill, that result from Customer's use, attempted use, or inability to use BESTDirect™.

18. EXTRAORDINARY EVENTS.

PFGBEST shall not be liable for losses caused directly or indirectly by government restrictions, exchange or market actions, suspension of trading, war, strikes, or for delays in the transmission of orders due to breakdown or failure of transmission or communication facilities, or as a result of any other causes beyond PFGBEST's control or anticipation.

Without limiting the generality of the foregoing, PFGBEST shall not be liable for any loss, liability, expense, fine or tax caused directly or indirectly by any (i) governmental, judicial, exchange or other self-regulatory organization action or order, (ii) suspension or termination of trading, (iii) breakdown or failure of transmission or communication facilities, or (iv) failure or delay by any exchange to enforce its rules or to pay or return any amounts owed to PFGBEST with respect to any transactions or contracts executed and/or cleared for Customer's account(s) with PFGBEST. In no event shall PFGBEST be liable for consequential, incidental or special damages.

19. CURRENCY FLUCTUATION RISK.

If Customer directs PFGBEST to enter into any commodity futures or commodity option on futures contract and such transaction is to be effected in a foreign currency: (a) any profit or loss arising as a result of a fluctuation in the exchange rate affecting such currency will be entirely for Customer's Account and Customer's risk; (b) all initial and subsequent deposits for margin purposes shall be made in U.S. dollars, in such amounts as PFGBEST may in its sole discretion require; and (c) PFGBEST is authorized to convert funds in Customer's Account into and from such foreign currency at a rate of exchange on the basis of the then prevailing money market rates as determined by PFGBEST in its sole discretion.

20. CUSTOMER'S ACKNOWLEDGEMENTS.

Customer acknowledges that investment in commodity futures contracts and commodity options on futures is speculative, involves a high degree of risk and is appropriate only for persons who can assume risk of loss in excess of their margin deposit. Customer understands that because of the low margin normally required in commodity futures trading, price changes in commodity futures contracts may result in significant losses, which losses may substantially exceed Customer's investment and margin deposit. Customer warrants that Customer is willing and able, financially and other wise, to assume the risk of trading commodities, and in consideration of PFGBEST's carrying Customer's Account(s) Customer agrees not to hold PFGBEST responsible for losses incurred through following PFGBEST's trading recommendations or suggestions or those of PFGBEST's employees, agents or representatives. Customer recognizes that guarantees of profit or freedom from loss are impossible in commodity trading. Customer acknowledges that Customer has received no such guarantees from PFGBEST or from any of PFGBEST's representatives or any introducing broker or other entity with whom Customer is conducting business in Customer's Account and has not entered into this Agreement in consideration of or in reliance upon any such guarantees or similar representations. Further Customer acknowledges that Customer has relied only on the terms and representations contained in this Agreement in formulating Customer's decision to open an account with PFGBEST.

Customer acknowledges that Customer has been advised and understands the following factors concerning trading Commodities, in addition to those contained in the CFTC Required Risk Disclosure Statement and Disclosure Statement for Non-Cash Margin, that have been provided to Customer. Customer further acknowledges that the purchase or sale of a futures contract always anticipates the accepting or making of delivery.

PFGBEST is not a member of the Securities Investor Protection Corporation ("SIPC"), therefore, Customer's account is not entitled to SIPC protection. Customer acknowledges that Customer's Accounts at PFGBEST are neither securities accounts protected under SIPC nor bank accounts protected by the FDIC.

Customer acknowledges that the accuracy, completeness, timeliness, and correct sequencing of the real-time information concerning Customer's trading and account activity, the quotes, market news, charts, trading analysis and strategies are not guaranteed by PFGBEST or PFGBEST's information providers. Customer understands that some of the information available through BESTDirect™ may be supplied by various independent sources. While PFGBEST believes that these independent sources are reliable, PFGBEST does not guarantee the accuracy, completeness, timeliness, non-interruption, or sequencing of any information supplied. Further, the information provided may be the property of the party who supplies such and may be protected by copyright; therefore, any reproduction, transmittal, dissemination or distribution of the information in any form or manner is prohibited without the express written consent of PFGBEST.

Customer further acknowledges that from time to time, and for any reason BESTDirect™ may not be operational or otherwise available for Customer's use due to servicing, hardware malfunction, software defect, service or transmission interruption or other cause, and Customer agrees to hold PFGBEST and its agents harmless from liability or any damage which results from the unavailability of BESTDirect™. Customer acknowledges that Customer has alternative arrangements, which will remain in place for the transmission and/or execution of

Customer's orders, by telephone, facsimile transmission or otherwise, in the event, for any reason, circumstances prevent the transmission and/or execution of all, or any portion of, Customer's orders through BESTDirect™. In the event that BESTDirect™ is not operational, Customer agrees to contact Customer's broker at PFGBEST to make alternative order entry arrangements.

Customer further acknowledges that there is risk associated with Currency Forex trading. If trading liquidity decreases, trading in a certain foreign currency may cease, thereby preventing the liquidation of an adverse position, which may result in a substantial financial loss. Additionally, there are no guarantees to the credit worthiness of the counterparty PFGBEST utilizes for Customer's Currency Forex position. If Customer directs PFGBEST to enter into any Currency Forex contract: (a) any profit or loss arising as a result of a fluctuation in the exchange rate affecting such currency will be entirely for Customer's Account and Customer's risk; and (b) all initial and subsequent deposits for margin purposes shall be made in U.S. dollars, in such amounts as PFGBEST may, in its sole discretion, require.

If Customer trades through the Forex market, Customer may not be afforded certainty of the protective measures provided by any domestic futures exchange, including the right to arbitrate Customer's dispute with the counterparty. For additional risk factors associated with Currency Forex, Customer should refer to the Currency Forex Risk Disclosure Statement, a copy of which has been provided to Customer.

If Customer's Account is introduced by an IB or by a CTA, it is being carried on PFGBEST's books on a "fully disclosed basis." Customer understands that PFGBEST is employed to perform certain bookkeeping and operational functions with regard to Customer's Account. Customer understands that PFGBEST is responsible for executing and confirming transactions effected for Customer's Account; segregating funds in accordance with the rules and regulations promulgated by the CFTC; margining Customer's Account and collecting funds on Customer's behalf by means of checks payable to PFGBEST only. Customer agrees to indemnify PFGBEST and hold harmless PFGBEST from and against all damages or liability arising from the conduct of Customer's IB or CTA.

21. TRADING RECOMMENDATIONS.

Customer acknowledges that (i) any market recommendations and information communicated by PFGBEST does not constitute an offer to sell or the solicitation of an offer to buy any commodity or commodity futures contract or options on futures contract; (ii) such recommendation and information, although based upon information obtained from sources believed by PFGBEST to be reliable, may be based solely on a broker's opinion and that such information may be incomplete and may be unverified; and (iii) PFGBEST makes no representation, warranty or guarantee as to, and shall not be responsible for, the accuracy or completeness of any information or trading recommendation furnished to Customer. The market recommendations of PFGBEST are based solely on the judgment of PFGBEST's personnel. These market recommendations may or may not be consistent with the market position or intentions of PFGBEST, PFGBEST's affiliates and employees.

Customer acknowledges that PFGBEST and/or PFGBEST's officers, directors, affiliates, associates, stockholders or representatives may have a position in or may intend to buy or sell commodities, commodity futures contracts or Commodity Options which are the subject of market recommendations furnished to Customer, and that the market position of PFGBEST or any such officer, director, affiliate, associate, stockholder or representative may not be consistent with the recommendations furnished to Customer by PFGBEST. Customer acknowledges that PFGBEST makes no representations concerning the tax implications or treatment of contracts.

22. TRADING AGENTS.

Customer acknowledges that should Customer grant trading authority or control over Customer's Account to a third-party ("Trading Agent"), whether on a discretionary or non-discretionary basis, PFGBEST shall in no way be responsible for reviewing Customer's choice of such Trading Agent nor making any recommendations with respect thereto. Customer understands that PFGBEST makes no warranties or representations concerning any Trading Agent; nor does PFGBEST by implication or otherwise, endorse or approve of the operating methods of the Trading Agent. Customer agrees that PFGBEST shall not be held responsible for any loss to Customer occasioned by the actions of the Trading Agent. If Customer gives Trading Agent authority to exercise any of its rights over its accounts, Customer understands that Customer does so at Customer's own risk.

Customer understands that PFGBEST does not permit its Account Executives to either exercise discretion or manage an account, or hold a power of attorney over an account, unless approved by an executive officer of PFGBEST and only after proper documentation has been submitted and approved by PFGBEST. If Customer's Account is not being traded with Customer's authorization, Customer must notify PFGBEST's Compliance Officer immediately.

23. CUSTOMER REPRESENTATIONS AND WARRANTIES.

Customer represents and warrants that: (a) Customer is of sound mind, legal age and legal competence; (b) no person other than Customer has or will have an interest in Customer's Account(s); (c) regardless of any subsequent determination to the contrary Customer is suitable to trade Commodities; and, (d) Customer is not now an employee of any exchange, any corporation in which any exchange owns a majority of the capital stock, any member of any exchange or a firm registered on any exchange, or any bank, trust, or insurance company; and in the event that Customer becomes so employed, Customer will promptly notify PFGBEST at its home office in writing of such employment; and, (e) all the information provided in the information portion of this booklet is true, correct and complete as of the date hereof and Customer will notify PFGBEST promptly of any changes in such information.

24. DISCLOSURE OF FINANCIAL INFORMATION.

Customer represents and warrants that the financial information disclosed to PFGBEST in this document is an accurate representation of Customer's current financial condition. Further, Customer represents and warrants that in determining:

(a) Customer's Net Worth: Assets and Liabilities were carefully calculated then Liabilities were subtracted from Assets to determine Customer's Net Worth;

(b) Value of Assets: Customer included cash and/or cash equivalents, U.S. Government and Marketable securities, real estate owned (excluding primary residence), the cash value of life insurance and other valuable Assets;

(c) Value of Liabilities: Customer included notes payable to banks (secured and unsecured), notes payable to relatives, real estate mortgages (excluding primary residence) and other debts; and

(d) Customer's Liquid Assets: Customer included only those Assets that can be quickly, (within one day's time) converted to Cash.

Customer represents and warrants that Customer has very carefully considered the portion of Customer's Assets that Customer considers being Risk Capital. Customer recognizes that Risk Capital is the amount of money Customer is willing to put at risk and if lost would not, in any way, change Customer's life style. Customer agrees to immediately inform PFGBEST if Customer's financial condition changes in such a way that reduces Customer's Net Worth, Liquid Assets and/or Risk Capital.

Customer authorizes PFGBEST or PFGBEST's agents to investigate Customer's credit standing and in connection therewith to contact such banks, financial institutions and credit agencies as PFGBEST shall deem appropriate to verify information regarding Customer. Customer further authorizes PFGBEST to investigate Customer's current and past investment activity and in connection therewith, to contact such futures commission merchants, exchanges, broker/dealers, and compliance data centers, as PFGBEST shall deem appropriate. Upon reasonable request made in writing by Customer to PFGBEST, Customer shall be allowed to review any records maintained by PFGBEST relating to Customer's credit standing. At Customer's sole cost and expense Customer also shall be allowed to copy such records.

PFGBEST has adopted policies and procedures for the protection of Customer's confidential personal information from unauthorized disclosure. PFGBEST's policies and procedures regarding such matters are reflected in the PFGBEST Privacy Notice. PFGBEST's Privacy Notice may also be obtained from PFGBEST's website at www.pfgbest.com.

25. NO GUARANTEES.

Customer acknowledges that Customer neither has any separate agreement nor shall enter into any separate agreement with Customer's broker or any PFGBEST employee or agent regarding the trading in Customer's Account, including any agreement to guarantee profits or limit losses in Customer's Account. Customer understands that Customer is under an obligation to notify PFGBEST's Compliance Officer immediately in writing as to any agreement of this type. Further, Customer understands that any representations made by anyone concerning Customer's Account, which differ from any statements Customer receives from PFGBEST must be brought immediately in writing to the attention of PFGBEST's Compliance Officer. Customer understands that Customer must authorize every transaction prior to its execution unless Customer has delegated discretion to another party by signing PFGBEST's limited trading authorization. Any disputed transactions must be brought to the attention of PFGBEST's Compliance Officer pursuant to the notice requirements of this Customer Agreement. Customer agrees to indemnify and hold PFGBEST harmless from all damages or liabilities resulting from Customer's failure to immediately notify PFGBEST's Compliance Officer of any of the occurrences referred to herein. All notices required under this section shall be sent to PFGBEST at PFGBEST's address appearing on confirmations and account statements.

26. JOINT ACCOUNTS.

If this account is held by more than one (1) person, all of the joint holders are jointly and severally liable to PFGBEST for any and all obligations arising out of transactions in the account and/or this Customer Agreement. Customer acknowledges that each tenant of a joint account has authority to: a) trade for the account, b) receive all correspondence and documents in respect to the account, c) receive or withdraw money, d) execute agreements relating to the account, and e) deal with PFGBEST fully. PFGBEST has the authority to require joint action by the parties of the Account in matters relating to the Account. PFGBEST has control and possession of the security of the Account individually or jointly. If a death occurs to one or more of the tenants, the remaining tenants shall notify PFGBEST in writing. For all expenses incurred by the Account, the Account shall be charged and all tenants shall be jointly and individually responsible. Unless the Customer informs PFGBEST otherwise, each tenant is presumed to have equal interest in the Account.

27. PARTNERSHIP ACCOUNTS.

Where the Customer is a partnership, the Customer represents that the General or Limited Partnership Agreement is in writing and provides that the partnership will not terminate upon the death or incapacity of any one of the partners; the partners and the partnership are in compliance with and shall remain in compliance with all rules and regulations applicable to their activities including, but not limited to, the rules and regulations of the CFTC, NFA, the Commodity Exchange Act, and State Laws in which the partnership was formed; the partners are jointly and severally liable to PFGBEST for any and all transactions and obligations made in conjunction with this account and are bound by all terms and conditions of this Agreement; and the partnership shall promptly notify PFGBEST in writing of the death or retirement of any partner, or any change in the partnership agreement. The estate of any of the general partners who shall have died shall be liable, and each survivor shall continue to be liable, to PFGBEST for any debit balance or loss in the account resulting from the completion of transactions initiated prior to receipt by PFGBEST of such written notice of death or incurred in the liquidation of the account after receipt of notice of death of a partner.

28. ERISA PENSION PLAN ACCOUNTS.

Where the Customer is a plan covered by the Employee Retirement Security Act of 1974 ("ERISA"), Customer acknowledges and understands that PFGBEST is only providing services hereunder and is not a plan fiduciary as defined in ERISA, and any rules or regulations promulgated thereunder. PFGBEST has no discretionary authority or control with respect to Customer's purchase or sale of futures contracts and that the furnishing of market recommendations and information by PFGBEST is solely for Customer's convenience and does not constitute the exercise of such authority or control; and there is no agreement, arrangement, or understanding between Customer and PFGBEST for investment decisions with respect to the assets of Customer or that PFGBEST will render individualized investment advice to Customer based on the particular needs of Customer. Customer further represents that it has full power and authority pursuant to governing agreements and otherwise to enter into this Agreement and to engage in transactions of the kind contemplated herein.

29. NO WAIVER OR AMENDMENT.

No provision of this Agreement may be waived or amended unless the waiver or amendment is in writing and signed by both Customer and an authorized officer of PFGBEST. No waiver or amendment of this Agreement may be implied from any course of dealing between the parties or from any failure by PFGBEST or PFGBEST's agents to assert PFGBEST's right under this Agreement on any occasion or series of occasions. No oral agreements or instructions to the contrary shall be recognized or enforceable. This instrument and the attachments hereto embody the entire agreement of the parties, superseding any and all prior written and oral agreements and there are no other terms, conditions or obligations other than those contained herein.

30. GOVERNING LAW AND JURISDICTION.

This Agreement, and the parties' rights and obligations hereto, shall be governed by, construed and enforced in all respects by the laws of the State of Illinois.

If any provision or condition of this Agreement shall be held to be invalid or unenforceable by any court, regulatory or self-regulatory agency or body, such invalidity or unenforceability shall attach only to such provision or condition. The validity of the remaining provisions and conditions shall not be affected and this Agreement shall be carried out as if any such invalid or unenforceable provision or condition was not contained herein. This Agreement or any section thereof shall not be construed against any party due to the fact that said Agreement or any section thereof was drafted by said party.

31. FOREIGN CUSTOMER NOTICE.

Where Customer is not a resident of the United States (hereinafter referred to as "Foreign Customer"), Regulation 15:05 of the United States Code of Federal Regulations (CFR) deems PFGBEST to be Foreign Customer's agent for purposes of accepting delivery and service of any communication issued by or on behalf of the CFTC with respect to any futures or options contracts which are or have been maintained in Foreign Customer's account carried by PFGBEST. Service or delivery of any communication issued by or on behalf of the CFTC to PFGBEST constitutes valid and effective service or delivery upon the Foreign Customer. Further, pursuant to Regulation 18:07 CFR, may required a Foreign Customer to comply with the filing of various reports with the CFTC upon twenty days notice, except where such Foreign Customer may be required by the CFTC to file such reports within one business day after a special call by the CFTC upon such Foreign Customer. In the event that the CFTC, pursuant to Regulation 21:03 CFR issues a call for information on the account of a Foreign Customer, PFGBEST, as your agent, may be required to provide any and all information concerning Foreign Customer's account, including but not limited to Foreign Customer's name and address and the name and address of persons having a ten percent or more beneficial interest in the account, total open futures and options positions in the account and the number of futures contracts against which delivery notices have been issued or received or against which exchanges of futures for cash have been transacted for the period of time specified in the call.

32. TERMINATION.

This Agreement shall continue in effect until termination. Customer may terminate this Agreement only at a time when Customer has no open commodity positions and no liabilities held by or owed to PFGBEST. Termination by Customer shall be effective upon the actual receipt by PFGBEST, at PFGBEST's main office, of written notice of termination. PFGBEST may terminate this Agreement at any time. If PFGBEST elects to terminate this Agreement, PFGBEST shall have the right, in PFGBEST's sole discretion, to sell any property in any account of the Customer, and to close out and liquidate any and all outstanding transactions of Customer, and any such sales or purchases shall be at PFGBEST's discretion on any exchange or other market. Prior demand, call or notice of the time and place of such sale or purchase, shall not be construed to be a waiver of PFGBEST's rights to sell or to buy without demand or notice. Termination by PFGBEST shall be effective upon the transmittal of written notice of termination to Customer. Customer's obligations to PFGBEST arising out of any deficit balance or indemnification shall survive the termination of this Agreement.

33. INDEMNIFICATION.

Customer agrees to indemnify and hold harmless PFGBEST, PFGBEST's affiliates, employees, agents, successors and assigns from and against any and all liabilities, losses, damages, costs and expenses, including attorney's fees, incurred by PFGBEST arising out of Customer's failure to fully and timely perform Customer's agreements herein or should any of the representations and warranties fail to be true and correct. Customer also agrees to be responsible for and pay promptly to PFGBEST all damages, costs and expenses, including attorney's fees, incurred by PFGBEST in the enforcement of any of the provisions of this Agreement and any other agreements between PFGBEST and Customer. Should customer instigate any legal action against PFGBEST and is unsuccessful, Customer agrees to indemnify PFGBEST for all cost PFGBEST incurs, including but not limited to attorneys' fees.

34. CROSS TRADE CONSENT.

Customer acknowledges and agrees that a situation may arise whereby an officer, director, affiliate, associate, employee, floor broker or floor trader associated with PFGBEST may be the opposing broker for a trade entered for Customer's Account. Customer consents to any such transaction, subject to any limitations and conditions contained in the Rules or Regulations of any bank, institution, exchange or board of trade upon which such buy or sell orders are executed, the CFTC, NFA, or the United States Federal Reserve Board, or any other regulatory agency.

35. ELECTRONIC MARKET CONSENT.

Customer authorizes PFGBEST to enter orders to buy and sell futures contracts on the GLOBEX®, the NYMEX ACCESS™, and/or the PROJECT A® automated order entry and matching system(s). Customer acknowledges having read and understood the Automated Order Entry Systems Disclosure Statement.

36. LINKED MARKET CONSENT.

PFGBEST may from time to time execute transactions as Customer's agent on a foreign futures exchange to trade futures, options, and/or Exchange for Physical Commodities, (EFP), pursuant to an agreement between the foreign futures exchange and a domestic futures exchange that a trade executed on one exchange liquidates or establishes a position on the other exchange. Customers who trade on a foreign futures exchange may not be afforded certainty of the protective measures provided by the Commodity Exchange Act, as amended, the CFTC's regulations, and the rules of NFA, and any domestic futures exchange, including the right to use reparation proceedings before the CFTC and arbitration proceedings provided by NFA or any domestic futures exchange. Customer authorizes PFGBEST to trade on foreign futures exchanges. Customer understands that Customer may be giving up the right to have arbitration in association with trades on foreign exchanges.

37. TERMS AND HEADINGS.

The term "PFGBEST" shall be deemed to include Peregrine Financial Group, Inc., PFGBEST's divisions, its successors and assigns. The term "Customer" shall mean the party (or parties) executing the Agreement. The term "Agreement" shall include all other agreements and authorizations executed by Customer in connection with the maintenance of Customer's Account regardless of when executed. The paragraph headings in this Agreement are inserted for convenience of reference only and are not deemed to limit the applicability or affect the meaning of any of its provisions.

38. BINDING EFFECT AND ACCEPTANCE.

This Agreement shall be continuous and shall cover, individually and collectively, all accounts of Customer at any time opened or reopened with PFGBEST, irrespective of any change or changes at any time in the personnel of PFGBEST or PFGBEST's successors, assigns, or affiliates. This Agreement, including all authorizations, shall inure to the benefit of PFGBEST and PFGBEST's successors and assigns, whether by merger, consolidation or otherwise, and shall be binding upon Customer and/or the heirs, estate, executor, trustees, administrators, legal representatives, successors, and assigns of Customer. Customer hereby ratifies all transactions with PFGBEST effected prior to the date of this Agreement, and agrees that the rights and obligations of Customer in respect thereto shall be governed by the terms of this Agreement. The parties agree that this Agreement shall not be deemed to have been accepted by PFGBEST or become a binding contract between Customer and PFGBEST until approved at PFGBEST's main office and signed by PFGBEST's authorized representative.

This statement is Required to be Furnished to You in Accordance with Rule 1.55, Rule 30.6 and Rule 33.7 of The Commodity Exchange Act. This brief statement does not disclose all of the risks and other significant aspects of trading in futures and options. In light of the risks, you should undertake such transactions only if you understand the nature of the contracts (and contractual relationships) into which you are entering and the extent of your exposure to risk. Trading in futures and options is not suitable for many members of the public. You should carefully consider whether trading is appropriate for you in light of your experience, objectives, financial resources and other relevant circumstances.

Futures

1. EFFECT OF 'LEVERAGE' OR 'GEARING'

Transactions in futures carry a high degree of risk. The amount of initial margin is small relative to the value of the futures contract so that transactions are 'leveraged' or 'geared'. A relatively small market movement will have a proportionately larger impact on the funds you have deposited or will have to deposit: this may work against you as well as for you. You may sustain a total loss of initial margin funds and any additional funds deposited with the firm to maintain your position. If the market moves against your position or margin levels are increased, you may be called upon to pay substantial additional funds on short notice to maintain your position. If you fail to comply with a request for additional funds within the time prescribed, your position may be liquidated at a loss and you will be liable for any resulting deficit.

2. RISK-REDUCING ORDERS OR STRATEGIES

The placing of certain orders (e.g. 'stop-loss' orders, where permitted under local law, or 'stop-limit' orders) which are intended to limit losses to certain amounts may not be effective because market conditions may make it impossible to execute such orders. Strategies using combinations of positions, such as 'spread' and 'straddle' positions may be as risky as taking simple 'long' or 'short' positions.

Options

3. VARIABLE DEGREE OF RISK

Transactions in options carry a high degree of risk. Purchasers and sellers of options should familiarize themselves with the type of option (i.e. put or call) which they contemplate trading and the associated risks. You should calculate the extent to which the value of the options must increase for your position to become profitable, taking into account the premium and all transaction costs.

The purchaser of options may offset or exercise the options or allow the options to expire. The exercise of an option results either in a cash settlement or in the purchaser acquiring or delivering the underlying interest. If the option is on a future, the purchaser will acquire a futures position with associated liabilities for margin (see the section on Futures above). If the purchased options expire worthless, you will suffer a total loss of your investment which will consist of the option premium plus transaction costs. If you are contemplating purchasing deep-out-of-the-money options, you should be aware that the chance of such options becoming profitable ordinarily is remote. Selling ('writing' or 'granting') an option generally entails considerably greater risk than purchasing options. Although the premium received by the seller is fixed, the seller may sustain a loss well in excess of that amount. The seller will be liable for additional margin to maintain the position if the market moves unfavorably. The seller will also be exposed to the risk of the purchaser exercising the option and the seller will be obligated to either settle the option in cash or to acquire or deliver the underlying interest. If the option is on a future, the seller will acquire a position in a future with associated liabilities for margin (see the section on Futures above). If the position is 'covered' by the seller holding a corresponding position in the underlying interest or a future or another option, the risk may be reduced. If the option is not covered, the risk of loss can be unlimited.

Certain exchanges in some jurisdictions permit deferred payment of the option premium, exposing the purchaser to liability for margin payments not exceeding the amount of the premium. The purchaser is still subject to the risk of losing the premium and transaction costs. When the option is exercised or expires, the purchaser is responsible for any unpaid premium outstanding at that time.

Additional risks common to futures and options

4. TERMS AND CONDITIONS OF CONTRACTS

You should ask the firm with which you deal about the term and conditions of the specific futures or options which you are trading and associated obligations (e.g. the circumstances under which you may become obligated to make or take delivery of the underlying interest of a futures contract and, in respect of options, expiration dates and restrictions on the time for exercise). Under certain circumstances the specifications of outstanding contracts (including the exercise price of an option) may be modified by the exchange or clearing house to reflect changes in the underlying interest.

5. SUSPENSION OR RESTRICTION OF TRADING AND PRICING RELATIONSHIPS

Market conditions (e.g. illiquidity) and/or the operation of the rules of certain markets (e.g. the suspension of trading in any contract or contract month because of price limits or 'circuit breakers') may increase the risk of loss by making it difficult or impossible to effect transactions or liquidate/off-set positions. If you have sold options, this may increase the risk of loss.

Further, normal pricing relationships between the underlying interest and the future, and the underlying interest and the option may not exist. This can occur when, for example, the futures contract underlying the option is subject to price limits while the option is not. The absence of an underlying reference price may make it difficult to judge 'fair' value.

6. DEPOSITED CASH AND PROPERTY

You should familiarize yourself with the protections accorded money or other property you deposit for domestic and foreign transactions, particularly in the event of a firm insolvency or bankruptcy. The extent to which you may recover your money or property may be governed by specified legislation or local rules. In some jurisdictions, property which had been specifically identifiable as your own will be prorated in the same manner as cash for purposes of distribution in the event of a shortfall.

7. COMMISSION AND OTHER CHARGES

Before you begin to trade, you should obtain a clear explanation of all commission, fees and other charges for which you will be liable. These charges will affect your net profit (if any) or increase your loss.

BECAUSE OF THE VOLATILE NATURE OF THE COMMODITIES MARKETS, THE PURCHASE AND GRANTING OF COMMODITY OPTIONS INVOLVE A HIGH DEGREE OF RISK. COMMODITY OPTION TRANSACTIONS ARE NOT SUITABLE FOR MANY MEMBERS OF THE PUBLIC. SUCH TRANSACTIONS SHOULD BE ENTERED INTO ONLY BY PERSONS WHO HAVE READ AND UNDERSTOOD THIS DISCLOSURE STATEMENT AND WHO UNDERSTAND THE NATURE AND EXTENT OF THEIR RIGHTS AND OBLIGATIONS AND OF THE RISKS INVOLVED IN THE OPTION TRANSACTIONS COVERED BY THIS DISCLOSURE STATEMENT.

BOTH THE PURCHASER AND THE GRANTOR SHOULD KNOW WHETHER THE PARTICULAR OPTION IN WHICH THEY CONTEMPLATE TRADING IS AN OPTION WHICH, IF EXERCISED, RESULTS IN THE ESTABLISHMENT OF A FUTURES CONTRACT (AN "OPTION ON A FUTURES CONTRACT") OR RESULTS IN THE MAKING OR TAKING OF DELIVERY OF THE ACTUAL COMMODITY UNDERLYING THE OPTION (AN "OPTION ON A PHYSICAL COMMODITY"). BOTH THE PURCHASER AND THE GRANTOR OF AN OPTION ON A PHYSICAL COMMODITY SHOULD BE AWARE THAT, IN CERTAIN CASES, THE DELIVERY OF THE ACTUAL COMMODITY UNDERLYING THE OPTION MAY NOT BE REQUIRED AND THAT, IF THE OPTION IS EXERCISED, THE OBLIGATIONS OF THE PURCHASER AND GRANTOR WILL BE SETTLED IN CASH.

BOTH THE PURCHASER AND THE GRANTOR SHOULD KNOW WHETHER THE PARTICULAR OPTION IN WHICH THEY CONTEMPLATE TRADING IS SUBJECT TO A "STOCK-STYLE" OR "FUTURES-STYLE" SYSTEM OF MARGINING. UNDER A STOCK-STYLE MARGINING SYSTEM, A PURCHASER IS REQUIRED TO PAY THE FULL PURCHASE PRICE OF THE OPTION AT THE INITIATION OF THE TRANSACTION. THE PURCHASER HAS NO FURTHER OBLIGATION ON THE OPTION POSITION. UNDER A FUTURES-STYLE MARGINING SYSTEM, THE PURCHASER DEPOSITS INITIAL MARGIN AND MAY BE REQUIRED TO DEPOSIT ADDITIONAL MARGIN IF THE MARKET MOVES AGAINST THE OPTION POSITION. THE PURCHASER'S TOTAL SETTLEMENT VARIATION MARGIN OBLIGATION OVER THE LIFE OF THE OPTION, HOWEVER, WILL NOT EXCEED THE ORIGINAL OPTION PREMIUM, ALTHOUGH SOME INDIVIDUAL PAYMENT OBLIGATIONS AND/OR RISK MARGIN REQUIREMENTS MAY AT TIMES EXCEED THE ORIGINAL OPTION PREMIUM. IF THE PURCHASER OR GRANTOR DOES NOT UNDERSTAND HOW OPTIONS ARE MARGINED UNDER A STOCK-STYLE OR FUTURES-STYLE MARGINING SYSTEM, HE OR SHE SHOULD REQUEST AN EXPLANATION FROM THE FUTURES COMMISSION MERCHANT ("FCM") OR INTRODUCING BROKER ("IB").

A PERSON SHOULD NOT PURCHASE ANY COMMODITY OPTION UNLESS HE OR SHE IS ABLE TO SUSTAIN A TOTAL LOSS OF THE PREMIUM AND TRANSACTION COSTS OF PURCHASING THE OPTION. A PERSON SHOULD NOT GRANT ANY COMMODITY OPTION UNLESS HE OR SHE IS ABLE TO MEET ADDITIONAL CALLS FOR MARGIN WHEN THE MARKET MOVES AGAINST HIS OR HER POSITION AND, IN SUCH CIRCUMSTANCES, TO SUSTAIN A VERY LARGE FINANCIAL LOSS.

A PERSON WHO PURCHASES AN OPTION SUBJECT TO STOCK-STYLE MARGINING SHOULD BE AWARE THAT, IN ORDER TO REALIZE ANY VALUE FROM THE OPTION, IT WILL BE NECESSARY EITHER TO OFFSET THE OPTION POSITION OR TO EXERCISE THE OPTION. OPTIONS SUBJECT TO FUTURES-STYLE MARGINING ARE MARKED TO MARKET, AND GAINS AND LOSSES ARE PAID AND COLLECTED DAILY. IF AN OPTION PURCHASER DOES NOT UNDERSTAND HOW TO OFFSET OR EXERCISE AN OPTION, THE PURCHASER SHOULD REQUEST AN EXPLANATION FROM THE FCM OR IB. CUSTOMERS SHOULD BE AWARE THAT IN A NUMBER OF CIRCUMSTANCES, SOME OF WHICH WILL BE DESCRIBED IN THIS DISCLOSURE STATEMENT, IT MAY BE DIFFICULT OR IMPOSSIBLE TO OFFSET AN EXISTING OPTION POSITION ON AN EXCHANGE.

THE GRANTOR OF AN OPTION SHOULD BE AWARE THAT, IN MOST CASES, A COMMODITY OPTION MAY BE EXERCISED AT ANY TIME FROM THE TIME IT IS GRANTED UNTIL IT EXPIRES. THE PURCHASER OF AN OPTION SHOULD BE AWARE THAT SOME OPTION CONTRACTS MAY PROVIDE ONLY A LIMITED PERIOD OF TIME FOR EXERCISE OF THE OPTION.
THE PURCHASER OF A PUT OR CALL SUBJECT TO STOCK-STYLE OR FUTURES-STYLE MARGINING IS SUBJECT TO THE RISK OF LOSING THE ENTIRE PURCHASE PRICE OF THE OPTION—THAT IS, THE PREMIUM CHARGED FOR THE OPTION PLUS ALL TRANSACTION COSTS.

THE COMMODITY FUTURES TRADING COMMISSION REQUIRES THAT ALL CUSTOMERS RECEIVE AND ACKNOWLEDGE RECEIPT OF A COPY OF THIS DISCLOSURE STATEMENT BUT DOES NOT INTEND THIS STATEMENT AS A RECOMMENDATION OR ENDORSEMENT OF EXCHANGE-TRADED COMMODITY OPTIONS.

(1) SOME OF THE RISKS OF OPTION TRADING.

Specific market movements of the underlying future or underlying physical commodity cannot be predicted accurately.

The grantor of a call option who does not have a long position in the underlying futures contract or underlying physical commodity is subject to risk of loss should the price of the underlying futures contract or underlying physical commodity be higher than the strike price upon exercise or expiration of the option by an amount greater than the premium received for granting the call option.

The grantor of a call option who has a long position in the underlying futures contract or underlying physical commodity is subject to the full risk of a decline in price or the underlying position reduced by the premium received for granting the call. In exchange for the premium received for granting a call option, the option grantor gives up all of the potential gain resulting from an increase in the price of the underlying futures contract or underlying physical commodity above the option strike price upon exercise or expiration of the option.

The grantor of a put option who does not have a short position in the underlying futures contract or underlying physical commodity (e.g., commitment to sell the physical) is subject to risk of loss should the price of the underlying futures contract or underlying physical commodity decrease below the strike price upon exercise or expiration of the option by an amount in excess of the premium received for granting the put option.

The grantor of a put option on a futures contract who has a short position in the underlying futures contract is subject to the full risk of a rise in the price in the underlying position reduced by the premium received for granting the put. In exchange for the premium received for granting a put option on a futures contract, the option grantor gives up all of the potential gain resulting from a decrease in the price of the underlying futures contract below the option strike price upon exercise or expiration of the option. The grantor of a put option on a physical commodity who has a short position (e.g., commitment to sell the physical) is subject to the full risk of a rise in the price of the physical commodity which must be obtained to fulfill the commitment reduced by the premium received for granting the put. In exchange for the premium, the grantor of a put option on a physical commodity gives up all the potential gain which would have resulted from a decrease in the price of the commodity below the option strike price upon exercise or expiration of the option.

(2) DESCRIPTION OF COMMODITY OPTIONS.

Prior to entering into any transaction involving a commodity option, an individual should thoroughly understand the nature and type of option involved and the underlying futures contract or physical commodity. The futures commission merchant or introducing broker is required to provide, and the individual contemplating an option transaction should obtain:

(i) An identification of the futures contract or physical commodity underlying the option and which may be purchased or sold upon exercise of the option or, if applicable, whether exercise of the option will be settled in cash;

(ii) The procedure for exercise of the option contract, including the expiration date and latest time on that date for exercise. (The latest time on an expiration date when an option may be exercised may vary; therefore, option market participants should ascertain from their futures commission merchant or their introducing broker the latest time the firm accepts exercise instructions with respect to a particular option.);

(iii) A description of the purchase price of the option including the premium, commissions, costs, fees and other charges. (Since commissions and other charges may vary widely among futures commission merchants and among introducing brokers, option customers may find it advisable to consult more than one firm when opening an option account.);

(iv) A description of all costs in addition to the purchase price which may be incurred if the commodity option is exercised, including the amount of commissions (whether termed sales commissions or otherwise), storage, interest, and all similar fees and charges which may be incurred;

(v) An explanation and understanding of the option margining system;

(vi) A clear explanation and understanding of any clauses in the option contract and of any items included in the option contract explicitly or by reference which might affect the customer's obligations under the contract. This would include any policy of the futures commission merchant or the introducing broker or rule of the exchange on which the option is traded that might affect the customer's ability to fulfill the option contract or to offset the option position in a closing purchase or closing sale transaction (for example, due to unforeseen circumstances that require suspension or termination of trading); and

(vii) If applicable, a description of the effect upon the value of the option position that could result from limit moves in the underlying futures contract.

(3) THE MECHANICS OF OPTION TRADING.

Before entering into any exchange-traded option transaction, an individual should obtain a description of how commodity options are traded.

Option customers should clearly understand that there is no guarantee that option positions may be offset by either a closing purchase or closing sale transaction on an exchange. In this circumstance, option grantors could be subject to the full risk of their positions until the option position expires, and the purchaser of a profitable option might have to exercise the option to realize a profit.

For an option on a futures contract, an individual should clearly understand the relationship between exchange rules governing option transactions and exchange rules governing the underlying futures contract. For example, an individual should understand what action, if any, the exchange will take in the option market if trading in the underlying futures market is restricted or the futures prices have made a "limit move."

The individual should understand that the option may not be subject to daily price fluctuation limits while the underlying futures may have such limits, and, as a result, normal pricing relationships between options and the underlying future may not exist when the future is trading at its price limit. Also, underlying futures positions resulting from exercise of options may not be capable of being offset if the underlying future is at a price limit.

(4) MARGIN REQUIREMENTS.

An individual should know and understand whether the option he or she is contemplating trading is subject to a stock-style or futures-style system of margining. Stock-style margining requires the purchaser to pay the full option premium at the time of purchase. The purchaser has no further financial obligations, and the risk of loss is limited to the purchase price and transaction costs. Futures-style margining requires the purchaser to pay initial margin only at the time of purchase. The option position is marked to market, and gains and losses are collected and paid daily. The purchaser's risk of loss is limited to the initial option premium and transaction costs.

An individual granting options under either a stock-style or futures-style system of margining should understand that he or she may be required to pay additional margin in the case of adverse market movements.

(5) PROFIT POTENTIAL OF AN OPTION POSITION.

An option customer should carefully calculate the price which the underlying futures contract or underlying physical commodity would have to reach for the option position to become profitable. Under a stock-style margining system, this price would include the amount by which the underlying futures contract or underlying physical commodity would have to rise above or fall below the strike price to cover the sum of the premium and all other costs incurred in entering into and exercising or closing (offsetting) the commodity option position. Under a future-style margining system, option positions would be marked to market, and gains and losses would be paid and collected daily, and an option position would become profitable once the variation margin collected exceeded the cost of entering the contract position.

Also, an option customer should be aware of the risk that the futures price prevailing at the opening of the next trading day may be substantially different from the futures price which prevailed when the option was exercised. Similarly, for options on physicals that are cash settled, the physicals price prevailing at the time the option is exercised may differ substantially from the cash settlement price that is determined at a later time. Thus, if a customer does not cover the position against the possibility of underlying commodity price change, the realized price upon option exercise may differ substantially from that which existed at the time of exercise.

(6) DEEP-OUT-OF-THE-MONEY OPTIONS.

A person contemplating purchasing a deep-out-of-the-money option (that is, an option with a strike price significantly above, in the case of a call, or significantly below, in the case of a put, the current price of the underlying futures contract or underlying physical commodity) should be aware that the chance of such an option becoming profitable is ordinarily remote.

On the other hand, a potential grantor of a deep-out-of-the-money option should be aware that such options normally provide small premiums while exposing the grantor to all of the potential losses described in section (1) of this disclosure statement.

(7) GLOSSARY OF TERMS.

(i) Contract market —Any board of trade (exchange) located in the United States which has been designated by the Commodity Futures Trading Commission to list a futures contract or commodity option for trading.

(ii) Exchange-traded option; put option; call option—The options discussed in this disclosure statement are limited to those which may be traded on a contract market. These options (subject to certain exceptions) give an option purchaser the right to buy in the case of a call option, or to sell in the case of a put option, a futures contract or the physical commodity underlying the option at the stated strike price prior to the expiration date of the option. Each exchange-traded option is distinguished by the underlying futures contract or underlying physical commodity, strike price, expiration date, and whether the option is a put or a call.

(iii) Underlying futures contract —The futures contract which may be purchased or sold upon the exercise of an option on a futures contract.

(iv) Underlying physical commodity—The commodity of a specific grade (quality) and quantity which may be purchased or sold upon the exercise of an option on a physical commodity.

(v) Class of options—A put or a call covering the same underlying futures contract or underlying physical commodity.

(vi) Series of options—Options of the same class having the same strike price and expiration date.

(vii) Exercise price—See strike price.

(viii) Expiration date—The last day when an option may be exercised.

(ix) Premium—The amount agreed upon between the purchaser and seller for the purchase or sale of a commodity option.

(x) Strike price—The price at which a person may purchase or sell the underlying futures contract or underlying physical commodity upon exercise of a commodity option. This term has the same meaning as the term "exercise price."

(xi) Short option position—See opening sale transaction.

(xii) Long option position—See opening purchase transaction.

(xiii) Types of options transactions—

(A) Opening purchase transaction—A transaction in which an individual purchases an option and thereby obtains a long option position.

(B) Opening sale transaction—A transaction in which an individual grants an option and thereby obtains a short option position.

(C) Closing purchase transaction—A transaction in which an individual with a short option position liquidates the position. This is accomplished by a closing purchase transaction for an option of the same series as the option previously granted. Such a transaction may be referred to as an offset transaction.

(D) Closing sale transaction—A transaction in which an individual with a long option position liquidates the position. This is accomplished by a closing sale transaction for an option of the same series as the option previously purchased. Such a transaction may be referred to as an offset transaction.

(xiv) Purchase price—The total actual cost paid or to be paid, directly or indirectly, by a person to acquire a commodity option. This price includes all commissions and other fees, in addition to the option premium.

(xv) Grantor, writer, seller—An individual who sells an option. Such a person is said to have a short position.

(xvi) Purchaser—An individual who buys an option. Such a person is said to have a long position.

Electronic Trading and Order Routing Systems Disclosure Statement*

Electronic trading and order routing systems differ from traditional open outcry pit trading and manual order routing methods. Transactions using an electronic system are subject to the rules and regulations of the exchange(s) offering the system and/or listing the contract. Before you engage in transactions using an electronic system, you should carefully review the rules and regulations of the exchange(s) offering the system and/or listing contracts you intend to trade.

DIFFERENCES AMONG ELECTRONIC TRADING SYSTEMS

Trading or routing orders through electronic systems varies widely among the different electronic systems. You should consult the rules and regulations of the exchange offering the electronic system and/or listing the contract traded or order routed to understand, among other things, in the case of trading systems, the system's order matching procedure, opening and closing procedures and prices, error trade policies, and trading limitations or requirements; and in the case of all systems, qualifications for access and grounds for termination and limitations on the types of orders that may be entered into the system. Each of these matters may present different risk factors with respect to trading on or using a particular system. Each system may also present risks related to system access, varying response times, and security. In the case of internet-based systems, there may be additional types of risks related to system access, varying response times and security, as well as risks related to service providers and the receipt and monitoring of electronic mail.

RISKS ASSOCIATED WITH SYSTEM FAILURE

Trading through an electronic trading or order routing system exposes you to risks associated with system or component failure. In the event of system or component failure, it is possible that, for a certain time period, you may not be able to enter new orders, execute existing orders, or modify or cancel orders that were previously entered. System or component failure may also result in loss of orders or order priority.

SIMULTANEOUS OPEN OUTCRY PIT AND ELECTRONIC TRADING

Some contracts offered on an electronic trading system may be traded electronically and through open outcry during the same trading hours. You should review the rules and regulations of the exchange offering the system and/or listing the contract to determine how orders that do not designate a particular process will be executed.

LIMITATION OF LIABILITY

Exchanges offering an electronic trading or order routing system and/or listing the contract may have adopted rules to limit their liability, the liability of FCMs, and software and communication system vendors and the amount of damages you may collect for system failure and delays. These limitations of liability provisions vary among the exchanges. You should consult the rules and regulations of the relevant exchange(s) in order to understand these liability limitations.

*Each exchange's relevant rules are available upon request from the industry professional with whom you have an account. Some exchange's relevant rules also are available on the exchange's internet home page.

This disclosure statement discusses the characteristics and risks of standardized security futures contracts traded on regulated U.S. exchanges. At present, regulated exchanges are authorized to list futures contracts on individual equity securities registered under the Securities Exchange Act of 1934 (including common stock and certain exchange-traded funds and American Depositary Receipts), as well as narrow-based security indices. Futures on other types of securities and options on security futures contracts may be authorized in the future. The glossary of terms appears at the end of the document.

Customers should be aware that the examples in this document are exclusive of fees and commissions that may decrease their net gains or increase their net losses. The examples also do not include tax consequences, which may differ for each customer.

SECTION 1 – RISKS OF SECURITY FUTURES

1.1. RISKS OF SECURITY FUTURES TRANSACTIONS

Trading security futures contracts may not be suitable for all investors. You may lose a substantial amount of money in a very short period of time. The amount you may lose is potentially unlimited and can exceed the amount you originally deposit with your broker. This is because futures trading is highly leveraged, with a relatively small amount of money used to establish a position in assets having a much greater value. If you are uncomfortable with this level of risk, you should not trade security futures contracts.

1.2. GENERAL RISKS

• *Trading security futures contracts involves risk and may result in potentially unlimited losses that are greater than the amount you deposited with your broker.* As with any high risk financial product, you should not risk any funds that you cannot afford to lose, such as your retirement savings, medical and other emergency funds, funds set aside for purposes such as education or home ownership, proceeds from student loans or mortgages, or funds required to meet your living expenses.

• *Be cautious of claims that you can make large profits from trading security futures contracts.* Although the high degree of leverage in security futures contracts can result in large and immediate gains, it can also result in large and immediate losses. As with any financial product, there is no such thing as a "sure winner."

• *Because of the leverage involved and the nature of security futures contract transactions, you may feel the effects of your losses immediately.* Gains and losses in security futures contracts are credited or debited to your account, at a minimum, on a daily basis. If movements in the markets for security futures contracts or the underlying security decrease the value of your positions in security futures contracts, you may be required to have or make additional funds available to your carrying firm as margin. If your account is under the minimum margin requirements set by the exchange or the brokerage firm, your position may be liquidated at a loss, and you will be liable for the deficit, if any, in your account. Margin requirements are addressed in Section 4.

• *Under certain market conditions, it may be difficult or impossible to liquidate a position.* Generally, you must enter into an offsetting transaction in order to liquidate a position in a security futures contract. If you cannot liquidate your position in security futures contracts, you may not be able to realize a gain in the value of your position or prevent losses from mounting. This inability to liquidate could occur, for example, if trading is halted due to unusual trading activity in either the security futures contract or the underlying security; if trading is halted due to recent news events involving the issuer of the underlying security; if systems failures occur on an exchange or at the firm carrying your position; or if the position is on an illiquid market. Even if you can liquidate your position, you may be forced to do so at a price that involves a large loss.

• *Under certain market conditions, it may also be difficult or impossible to manage your risk from open security futures positions by entering into an equivalent but opposite position in another contract month, on another market, or in the underlying security.* This inability to take positions to limit your risk could occur, for example, if trading is halted across markets due to unusual trading activity in the security futures contract or the underlying security or due to recent news events involving the issuer of the underlying security.

• *Under certain market conditions, the prices of security futures contracts may not maintain their customary or anticipated relationships to the prices of the underlying security or index.* These pricing disparities could occur, for example, when the market for the security futures contract is illiquid, when the primary market for the underlying security is closed, or when the reporting of transactions in the underlying security has been delayed. For index products, it could also occur when trading is delayed or halted in some or all of the securities that make up the index.

• *You may be required to settle certain security futures contracts with physical delivery of the underlying security.* If you hold your position in a physically settled security futures contract until the end of the last trading day prior to expiration, you will be obligated to make or take delivery of the underlying securities, which could involve additional costs. The actual settlement terms may vary from contract to contract and exchange to exchange. You should carefully review the settlement and delivery conditions before entering into a security futures contract. Settlement and delivery are discussed in Section 5.

• *You may experience losses due to systems failures.* As with any financial transaction, you may experience losses if your orders for security futures contracts cannot be executed normally due to systems failures on a regulated exchange or at the brokerage firm carrying your position. Your losses may be greater if the brokerage firm carrying your position does not have adequate back-up systems or procedures.

• *All security futures contracts involve risk, and there is no trading strategy that can eliminate it.* Strategies using combinations of positions, such as spreads, may be as risky as outright long or short positions. Trading in security futures contracts requires knowledge of both the securities and the futures markets.

• *Day trading strategies involving security futures contracts and other products pose special risks.* As with any financial product, persons who seek to purchase and sell the same security future in the course of a day to profit from intra-day price movements ("day traders") face a number of special risks, including substantial commissions, exposure to leverage, and competition with professional traders. You should thoroughly understand these risks and have appropriate experience before engaging in day trading. The special risks for day traders are discussed more fully in Section 7.

• *Placing contingent orders, if permitted, such as "stop-loss" or "stop-limit" orders, will not necessarily limit your losses to the intended amount.* Some regulated exchanges may permit you to enter into stop-loss or stop-limit orders for security futures contracts, which are intended to limit your exposure to losses due to market fluctuations. However, market conditions may make it impossible to execute the order or to get the stop price.

• *You should thoroughly read and understand the customer account agreement with your brokerage firm before entering into any transactions in security futures contracts.*

• *You should thoroughly understand the regulatory protections available to your funds and positions in the event of the failure of your brokerage firm.* The regulatory protections available to your funds and positions in the event of the failure of your brokerage firm may vary depending on, among other factors, the contract you are trading and whether you are trading through a securities account or a futures account. Firms that allow customers to trade security futures in either securities accounts or futures accounts, or both, are required to disclose to customers the differences in regulatory protections between such accounts, and, where appropriate, how customers may elect to trade in either type of account.

SECTION 2 – DESCRIPTION OF A SECURITY FUTURES CONTRACT

2.1. WHAT IS A SECURITY FUTURES CONTRACT?

A security futures contract is a legally binding agreement between two parties to purchase or sell in the future a specific quantity of shares of a security or of the component securities of a narrow-based security index, at a certain price. A person who buys a security futures contract enters into a contract to purchase an underlying security and is said to be "long" the contract. A person who sells a security futures contract enters into a contract to sell the underlying security and is said to be "short" the contract. The price at which the contract trades (the "contract price") is determined by relative buying and selling interest on a regulated exchange.

In order to enter into a security futures contract, you must deposit funds with your brokerage firm equal to a specified percentage (usually at least 20 percent) of the current market value of the contract as a performance bond. Moreover, all security futures contracts are marked-to-market at least daily, usually after the close of trading, as described in Section 3 of this document. At that time, the account of each buyer and seller reflects the amount of any gain or loss on the security futures contract based on the contract price established at the end of the day for settlement purposes (the "daily settlement price").

An open position, either a long or short position, is closed or liquidated by entering into an offsetting transaction (i.e., an equal and opposite transaction to the one that opened the position) prior to the contract expiration. Traditionally, most futures contracts are liquidated prior to expiration through an offsetting transaction and, thus, holders do not incur a settlement obligation.

Examples:

Investor A is long one September XYZ Corp. futures contract. To liquidate the long position in the September XYZ Corp. futures contract, Investor A would sell an identical September XYZ Corp. contract.

Investor B is short one December XYZ Corp. futures contract. To liquidate the short position in the December XYZ Corp. futures contract, Investor B would buy an identical December XYZ Corp. contract.

Security futures contracts that are not liquidated prior to expiration must be settled in accordance with the terms of the contract. Some security futures contracts are settled by physical delivery of the underlying security. At the expiration of a security futures contract that is settled through physical delivery, a person who is long the contract must pay the final settlement price set by the regulated exchange or the clearing organization and take delivery of the underlying shares. Conversely, a person who is short the contract must make delivery of the underlying shares in exchange for the final settlement price.

Other security futures contracts are settled through cash settlement. In this case, the underlying security is not delivered. Instead, any positions in such security futures contracts that are open at the end of the last trading day are settled through a final cash payment based on a final settlement price determined by the exchange or clearing organization. Once this payment is made, neither party has any further obligations on the contract.

Physical delivery and cash settlement are discussed more fully in Section 5.

2.2. PURPOSES OF SECURITY FUTURES

Security futures contracts can be used for speculation, hedging, and risk management. Security futures contracts do not provide capital growth or income.

SPECULATION

Speculators are individuals or firms who seek to profit from anticipated increases or decreases in futures prices. A speculator who expects the price of the underlying instrument to increase will buy the security futures contract. A speculator who expects the price of the underlying instrument to decrease will sell the security futures contract. Speculation involves substantial risk and can lead to large losses as well as profits.

The most common trading strategies involving security futures contracts are buying with the hope of profiting from an anticipated price increase and selling with the hope of profiting from an anticipated price decrease. For example, a person who expects the price of XYZ stock to increase by March can buy a March XYZ security futures contract, and a person who expects the price of XYZ stock to decrease by March can sell a March XYZ security futures contract. The following illustrates potential profits and losses if Customer A purchases the security futures contract at $50 a share and Customer B sells the same contract at $50 a share (assuming 100 shares per contract).

Price of XYZ at Liquidation	Customer A Profit/Loss	Customer B Proift/Loss
$55	$500	-$500
$50	$0	$0
$45	-$500	$500

Speculators may also enter into spreads with the hope of profiting from an expected change in price relationships. Spreaders may purchase) contract expiring in one contract month and sell another contract on the same underlying security expiring in a different month (e.g., buy June and sell September XYZ single stock futures). This is commonly referred to as a "calendar spread."

Spreaders may also purchase and sell the same contract month in two different but economically correlated security futures contracts. For example, if ABC and XYZ are both pharmaceutical companies and an individual believes that ABC will have stronger growth than XYZ between now and June, he could buy June ABC futures contracts and sell June XYZ futures contracts. Assuming that each contract is 100 shares, the following illustrates how this works.

Opening Position	Price at Liquidation	Gain or Loss	Price at Liquidation	Gain or Loss
Buy ABC at 50	$53	$300	$53	$300
Sell XYZ at 45	$46	-$100	$50	-$500
Net Gain or Loss	$200	-$200		

Speculators can also engage in arbitrage, which is similar to a spread except that the long and short positions occur on two different markets. An arbitrage position can be established by taking an economically opposite position in a security futures contract on another exchange, in an options contract, or in the underlying security.

HEDGING

Generally speaking, hedging involves the purchase or sale of a security future to reduce or offset the risk of a position in the underlying security or group of securities (or a close economic equivalent). A hedger gives up the potential to profit from a favorable price change in the position being hedged in order to minimize the risk of loss from an adverse price change.

An investor who wants to lock in a price now for an anticipated sale of the underlying security at a later date can do so by hedging with security futures. For example, assume an investor owns 1,000 shares of ABC that have appreciated since he bought them. The investor would like to sell them at the current price of $50 per share, but there are tax or other reasons for holding them until September. The investor could sell ten 100-share ABC futures contracts and then buy back those contracts in September when he sells the stock. Assuming the stock price and the futures price change by the same amount, the gain or loss in the stock will be offset by the loss or gain in the futures contracts.

Price in September	Value of 1,000 Shares of ABC	Gain or Loss on Futures	Price at Liquidation
$40	$40,000	$10,000	$50,000
$50	$50,000	$0	$50,000
$60	$60,000	-$10,000	$50,000

Hedging can also be used to lock in a price now for an anticipated purchase of the stock at a later date. For example, assume that in May a mutual fund expects to buy stocks in a particular industry with the proceeds of bonds that will mature in August. The mutual fund can hedge its risk that the stocks will increase in value between May and August by purchasing security futures contracts on a narrow-based index of stocks from that industry. When the mutual fund buys the stocks in August, it also will liquidate the security futures position in the index. If the relationship between the security futures contract and the stocks in the index is constant, the profit or loss from the futures contract will offset the price change in the stocks, and the mutual fund will have locked in the price that the stocks were selling at in May.

Although hedging mitigates risk, it does not eliminate all risk. For example, the relationship between the price of the security futures contract and the price of the underlying security traditionally tends to remain constant over time, but it can and does vary somewhat. Furthermore, the expiration or liquidation of the security futures contract may not coincide with the exact time the hedger buys or sells the underlying stock. Therefore, hedging may not be a perfect protection against price risk.

RISK MANAGEMENT

Some institutions also use futures contracts to manage portfolio risks without necessarily intending to change the composition of their portfolio by buying or selling the underlying securities. The institution does so by taking a security futures position that is opposite to some or all of its position in the underlying securities. This strategy involves more risk than a traditional hedge because it is not meant to be a substitute for an anticipated purchase or sale.

2.3. WHERE SECURITY FUTURES TRADE

By law, security futures contracts must trade on a regulated U.S. exchange. Each regulated U.S. exchange that trades security futures contracts is subject to joint regulation by the Securities and Exchange Commission (SEC) and the Commodity Futures Trading Commission (CFTC).

A person holding a position in a security futures contract who seeks to liquidate the position must do so either on the regulated exchange where the original trade took place or on another regulated exchange, if any, where a fungible security futures contract trades. (A person may also seek to manage the risk in that position by taking an opposite position in a comparable contract traded on another regulated exchange.)

Security futures contracts traded on one regulated exchange might not be fungible with security futures contracts traded on another regulated exchange for a variety of reasons. Security futures traded on different regulated exchanges may be non-fungible because they have different contract terms (e.g., size, settlement method), or because they are cleared through different clearing organizations. Moreover, a regulated exchange might not permit its security futures contracts to be offset or liquidated by an identical contract traded on another regulated exchange, even though they have the same contract terms and are cleared through the same clearing organization. You should consult your broker about the fungibility of the contract you are considering purchasing or selling, including which exchange(s), if any, on which it may be offset.

Regulated exchanges that trade security futures contracts are required by law to establish certain listing standards. Changes in the underlying security of a security futures contract may, in some cases, cause such contract to no longer meet the regulated exchange's listing standards. Each regulated exchange will have rules governing the continued trading of security futures contracts that no longer meet the exchange's listing standards. These rules may, for example, permit only liquidating trades in security futures contracts that no longer satisfy the listing standards.

2.4. HOW SECURITY FUTURES DIFFER FROM THE UNDERLYING SECURITY

Shares of common stock represent a fractional ownership interest in the issuer of that security. Ownership of securities confers various rights that are not present with positions in security futures contracts. For example, persons owning a share of common stock may be entitled to vote in matters affecting corporate governance. They also may be entitled to receive dividends and corporate disclosure, such as annual and quarterly reports.

The purchaser of a security futures contract, by contrast, has only a contract for future delivery of the underlying security. The purchaser of the security futures contract is not entitled to exercise any voting rights over the underlying security and is not entitled to any dividends that may be paid by the issuer. Moreover, the purchaser of a security futures contract does not receive the corporate disclosures that are received by shareholders of the underlying security, although such corporate disclosures must be made publicly available through the SEC's EDGAR system, which can be accessed at www.sec.gov. You should review such disclosures before entering into a security futures contract. See Section 9 for further discussion of the impact of corporate events on a security futures contract.

All security futures contracts are marked-to-market at least daily, usually after the close of trading, as described in Section 3 of this document. At that time, the account of each buyer and seller is credited with the amount of any gain, or debited by the amount of any loss, on the security futures contract, based on the contract price established at the end of the day for settlement purposes (the "daily settlement price"). By contrast, the purchaser or seller of the underlying instrument does not have the profit and loss from his or her investment credited or debited until the position in that instrument is closed out.

Naturally, as with any financial product, the value of the security futures contract and of the underlying security may fluctuate. However, owning the underlying security does not require an investor to settle his or her profits and losses daily. By contrast, as a result of the mark-to-market requirements discussed above, a person who is long a security futures contract often will be required to deposit additional funds into his or her account as the price of the security futures contract decreases. Similarly, a person who is short a security futures contract often will be required to deposit additional funds into his or her account as the price of the security futures contract increases.

Another significant difference is that security futures contracts expire on a specific date. Unlike an owner of the underlying security, a person cannot hold a long position in a security futures contract for an extended period of time in the hope that the price will go up. If you do not liquidate your security futures contract, you will be required to settle the contract when it expires, either through physical delivery or cash settlement. For cash-settled contracts in particular, upon expiration, an individual will no longer have an economic interest in the securities underlying the security futures contract.

2.5. COMPARISON TO OPTIONS

Although security futures contracts share some characteristics with options on securities (options contracts), these products are also different in a number of ways. Below are some of the important distinctions between equity options contracts and security futures contracts.

If you purchase an options contract, you have the right, but not the obligation, to buy or sell a security prior to the expiration date. If you sell an options contract, you have the obligation to buy or sell a security prior to the expiration date. By contrast, if you have a position in a security futures contract (either long or short), you have both the right and the obligation to buy or sell a security at a future date. The only way that you can avoid the obligation incurred by the security futures contract is to liquidate the position with an offsetting contract.

A person purchasing an options contract runs the risk of losing the purchase price (premium) for the option contract. Because it is a wasting asset, the purchaser of an options contract who neither liquidates the options contract in the secondary market nor exercises it at or prior to expiration will necessarily lose his or her entire investment in the options contract. However, a purchaser of an options contract cannot lose more than the amount of the premium. Conversely, the seller of an options contract receives the premium and assumes the risk that he or she will be required to buy or sell the underlying security on or prior to the expiration date, in which event his or her losses may exceed the amount of the premium received. Although the seller of an options contract is required to deposit margin to reflect the risk of its obligation, he or she may lose many times his or her initial margin deposit.

By contrast, the purchaser and seller of a security futures contract each enter into an agreement to buy or sell a specific quantity of shares in the underlying security. Based upon the movement in prices of the underlying security, a person who holds a position in a security futures contract can gain or lose many times his or her initial margin deposit. In this respect, the benefits of a security futures contract are similar to the benefits of purchasing an option, while the risks of entering into a security futures contract are similar to the risks of selling an option.

Both the purchaser and the seller of a security futures contract have daily margin obligations. At least once each day, security futures contracts are marked-to-market and the increase or decrease in the value of the contract is credited or debited to the buyer and the seller. As a result, any person who has an open position in a security futures contract may be called upon to meet additional margin requirements or may receive a credit of available funds.

Example:

Assume that Customers A and B each anticipate an increase in the market price of XYZ stock, which is currently $50 a share. Customer A purchases an XYZ 50 call (covering 100 shares of XYZ at a premium of $5 per share). The option premium is $500 ($5 per share X 100 shares). Customer B purchases an XYZ security futures contract (covering 100 shares of XYZ). The total value of the contract is $5000 ($50 share value X 100 shares). The required margin is $1000 (or 20% of the contract value).

Price of XYZ at Expiration	Customer A Profit/Loss	Customer B Profit/Loss
$65	$1000	$1500
$60	$500	$1000
$55	$0	$500
$50	-$500	$0
$45	-$500	-$500
$40	-$500	-$1000
$35	-$500	-$1500

The most that Customer A can lose is $500, the option premium. Customer A breaks even at $55 per share, and makes money at higher prices. Customer B may lose more than his initial margin deposit. Unlike the options premium, the margin on a futures contract is not a cost but a performance bond. The losses for Customer B are not limited by this performance bond. Rather, the losses or gains are determined by the settlement price of the contract, as provided in the example above. Note that if the price of XYZ falls to $35 per share, Customer A loses only $500, whereas Customer B loses $1500.

2.6. COMPONENTS OF A SECURITY FUTURES CONTRACT

Each regulated exchange can choose the terms of the security futures contracts it lists, and those terms may differ from exchange to exchange or contract to contract. Some of those contract terms are discussed below. However, you should ask your broker for a copy of the contract specifications before trading a particular contract.

2.6.1. Each security futures contract has a set size. The size of a security futures contract is determined by the regulated exchange on which the contract trades. For example, a security futures contract for a single stock may be based on 100 shares of that stock. If prices are reported per share, the value of the contract would be the price times 100. For narrow-based security indices, the value of the contract is the price of the component securities times the multiplier set by the exchange as part of the contract terms.

2.6.2. Security futures contracts expire at set times determined by the listing exchange. For example, a particular contract may expire on a particular day, e.g., the third Friday of the expiration month. Up until expiration, you may liquidate an open position by offsetting your contract with a fungible opposite contract that expires in the same month. If you do not liquidate an open position before it expires, you will be required to make or take delivery of the underlying security or to settle the contract in cash after expiration.

2.6.3. Although security futures contracts on a particular security or a narrow-based security index may be listed and traded on more than one regulated exchange, the contract specifications may not be the same. Also, prices for contracts on the same security or index may vary on different regulated exchanges because of different contract specifications.

2.6.4. Prices of security futures contracts are usually quoted the same way prices are quoted in the underlying instrument. For example, a contract for an individual security would be quoted in dollars and cents per share. Contracts for indices would be quoted by an index number, usually stated to two decimal places.

2.6.5. Each security futures contract has a minimum price fluctuation (called a tick), which may differ from product to product or exchange to exchange. For example, if a particular security futures contract has a tick size of 1¢, you can buy the contract at $23.21 or $23.22 but not at $23.215.

2.7. TRADING HALTS

The value of your positions in security futures contracts could be affected if trading is halted in either the security futures contract or the underlying security. In certain circumstances, regulated exchanges are required by law to halt trading in security futures contracts. For example, trading on a particular security futures contract must be halted if trading is halted on the listed market for the underlying security as a result of pending news, regulatory concerns, or market volatility. Similarly, trading of a security futures contract on a narrow-based security index must be halted under such circumstances if trading is halted on securities accounting for at least 50 percent of the market capitalization of the index. In addition, regulated exchanges are required to halt trading in all security futures contracts for a specified period of time when the Dow Jones Industrial Average ("DJIA") experiences one-day declines of 10-, 20- and 30-percent. The regulated exchanges may also have discretion under their rules to halt trading in other circumstances – such as when the exchange determines that the halt would be advisable in maintaining a fair and orderly market.

A trading halt, either by a regulated exchange that trades security futures or an exchange trading the underlying security or instrument, could prevent you from liquidating a position in security futures contracts in a timely manner, which could prevent you from liquidating a position in security futures contracts at that time.

2.8. TRADING HOURS

Each regulated exchange trading a security futures contract may open and close for trading at different times than other regulated exchanges trading security futures contracts or markets trading the underlying security or securities. Trading in security futures contracts prior to the opening or after the close of the primary market for the underlying security may be less liquid than trading during regular market hours.

SECTION 3 – CLEARING ORGANIZATIONS AND MARK-TO-MARKET REQUIREMENTS

Every regulated U.S. exchange that trades security futures contracts is required to have a relationship with a clearing organization that serves as the guarantor of each security futures contract traded on that exchange. A clearing organization performs the following functions: matching trades; effecting settlement and payments; guaranteeing performance; and facilitating deliveries.

Throughout each trading day, the clearing organization matches trade data submitted by clearing members on behalf of their customers or for the clearing member's proprietary accounts. If an account is with a brokerage firm that is not a member of the clearing organization, then the brokerage firm will carry the security futures position with another brokerage firm that is a member of the clearing organization. Trade records that do not match, either because of a discrepancy in the details or because one side of the transaction is missing, are returned to the submitting clearing members for resolution. The members are required to resolve such "out trades" before or on the open of trading the next morning.

When the required details of a reported transaction have been verified, the clearing organization assumes the legal and financial obligations of the parties to the transaction. One way to think of the role of the clearing organization is that it is the "buyer to every seller and the seller to every buyer." The insertion or substitution of the clearing organization as the counterparty to every transaction enables a customer to liquidate a security futures position without regard to what the other party to the original security futures contract decides to do.

The clearing organization also effects the settlement of gains and losses from security futures contracts between clearing members. At least once each day, clearing member brokerage firms must either pay to, or receive from, the clearing organization the difference between the current price and the trade price earlier in the day, or for a position carried over from the previous day, the difference between the current price and the previous day's settlement price. Whether a clearing organization effects settlement of gains and losses on a daily basis or more frequently will depend on the conventions of the clearing organization and market conditions. Because the clearing organization assumes the legal and financial obligations for each security futures contract, you should expect it to ensure that payments are made promptly to protect its obligations.

Gains and losses in security futures contracts are also reflected in each customer's account on at least a daily basis. Each day's gains and losses are determined based on a daily settlement price disseminated by the regulated exchange trading the security futures contract or its clearing organization. If the daily settlement price of a particular security futures contract rises, the buyer has a gain and the seller a loss. If the daily settlement price declines, the buyer has a loss and the seller a gain. This process is known as "marking-to-market" or daily settlement. As a result, individual customers normally will be called on to settle daily.

The one-day gain or loss on a security futures contract is determined by calculating the difference between the current day's settlement price and the previous day's settlement price.

For example, assume a security futures contract is purchased at a price of $120. If the daily settlement price is either $125 (higher) or $117 (lower), the effects would be as follows:
(1 contract representing 100 shares)

Daily Settlement Value	Buyer's Account	Seller's Account
$125	$500 gain (credit)	$500 loss (debit)
$117	$300 loss (debit)	$300 gain (credit)

The cumulative gain or loss on a customer's open security futures positions is generally referred to as "open trade equity" and is listed as a separate component of account equity on your customer account statement.
A discussion of the role of the clearing organization in effecting delivery is discussed in Section 5.

SECTION 4 – MARGIN AND LEVERAGE

When a broker-dealer lends a customer part of the funds needed to purchase a security such as common stock, the term "margin" refers to the amount of cash, or down payment, the customer is required to deposit. By contrast, a security futures contract is an obligation and not an asset. A security futures contract has no value as collateral for a loan. Because of the potential for a loss as a result of the daily marked-to-market process, however, a margin deposit is required of each party to a security futures contract. This required margin deposit also is referred to as a "performance bond."

In the first instance, margin requirements for security futures contracts are set by the exchange on which the contract is traded, subject to certain minimums set by law. The basic margin requirement is 20% of the current value of the security futures contract, although some strategies may have lower margin requirements. Requests for additional margin are known as "margin calls." Both buyer and seller must individually deposit the required margin to their respective accounts.

It is important to understand that individual brokerage firms can, and in many cases do, require margin that is higher than the exchange requirements. Additionally, margin requirements may vary from brokerage firm to brokerage firm. Furthermore, a brokerage firm can increase its "house" margin requirements at any time without providing advance notice, and such increases could result in a margin call.

For example, some firms may require margin to be deposited the business day following the day of a deficiency, or some firms may even require deposit on the same day. Some firms may require margin to be on deposit in the account before they will accept an order for a security futures contract. Additionally, brokerage firms may have special requirements as to how margin calls are to be met, such as requiring a wire transfer from a bank, or deposit of a certified or cashier's check. You should thoroughly read and understand the customer agreement with your brokerage firm before entering into any transactions in security futures contracts.

If through the daily cash settlement process, losses in the account of a security futures contract participant reduce the funds on deposit (or equity) below the maintenance margin level (or the firm's higher "house" requirement), the brokerage firm will require that additional funds be deposited.

If additional margin is not deposited in accordance with the firm's policies, the firm can liquidate your position in security futures contracts or sell assets in any of your accounts at the firm to cover the margin deficiency. You remain responsible for any shortfall in the account after such liquidations or sales. Unless provided otherwise in your customer agreement or by applicable law, you are not entitled to choose which futures contracts, other securities or other assets are liquidated or sold to meet a margin call or to obtain an extension of time to meet a margin call.

Brokerage firms generally reserve the right to liquidate a customer's security futures contract positions or sell customer assets to meet a margin call at any time without contacting the customer. Brokerage firms may also enter into equivalent but opposite positions for your account in order to manage the risk created by a margin call. Some customers mistakenly believe that a firm is required to contact them for a margin call to be valid, and that the firm is not allowed to liquidate securities or other assets in their accounts to meet a margin call unless the firm has contacted them first. This is not the case. While most firms notify their customers of margin calls and allow some time for deposit of additional margin, they are not required to do so. Even if a firm has notified a customer of a margin call and set a specific due date for a margin deposit, the firm can still take action as necessary to protect its financial interests, including the immediate liquidation of positions without advance notification to the customer.

Here is an example of the margin requirements for a long security futures position.

A customer buys 3 July EJG security futures at 71.50. Assuming each contract represents 100 shares, the nominal value of the position is $21,450 (71.50 x 3 contracts x 100 shares). If the initial margin rate is 20% of the nominal value, then the customer's initial margin requirement would be $4,290. The customer deposits the initial margin, bringing the equity in the account to $4,290.

First, assume that the next day the settlement price of EJG security futures falls to 69.25. The marked-to-market loss in the customer's equity is $675 (71.50 – 69.25 x 3 contacts x 100 shares). The customer's equity decreases to $3,615 ($4,290 – $675). The new nominal value of the contract is $20,775 (69.25 x 3 contracts x 100 shares). If the maintenance margin rate is 20% of the nominal value, then the customer's maintenance margin requirement would be $4,155. Because the customer's equity had decreased to $3,615 (see above), the customer would be required to have an additional $540 in margin ($4,155 – $3,615).

Alternatively, assume that the next day the settlement price of EJG security futures rises to 75.00. The mark-to-market gain in the customer's equity is \$1,050 (75.00 – 71.50 x 3 contacts x 100 shares). The customer's equity increases to \$5,340 (\$4,290 + \$1,050). The new nominal value of the contract is \$22,500 (75.00 x 3 contracts x 100 shares). If the maintenance margin rate is 20% of the nominal value, then the customer's maintenance margin requirement would be \$4,500. Because the customer's equity had increased to \$5,340 (see above), the customer's excess equity would be \$840.

The process is exactly the same for a short position, except that margin calls are generated as the settlement price rises rather than as it falls. This is because the customer's equity decreases as the settlement price rises and increases as the settlement price falls.

Because the margin deposit required to open a security futures position is a fraction of the nominal value of the contracts being purchased or sold, security futures contracts are said to be highly leveraged. The smaller the margin requirement in relation to the underlying value of the security futures contract, the greater the leverage. Leverage allows exposure to a given quantity of an underlying asset for a fraction of the investment needed to purchase that quantity outright. In sum, buying (or selling) a security futures contract provides the same dollar and cents profit and loss outcomes as owning (or shorting) the underlying security. However, as a percentage of the margin deposit, the potential immediate exposure to profit or loss is much higher with a security futures contract than with the underlying security.

For example, if a security futures contract is established at a price of \$50, the contract has a nominal value of \$5,000 (assuming the contract is for 100 shares of stock). The margin requirement may be as low as 20%. In the example just used, assume the contract price rises from \$50 to \$52 (a \$200 increase in the nominal value). This represents a \$200 profit to the buyer of the security futures contract, and a 20% return on the \$1,000 deposited as margin. The reverse would be true if the contract price decreased from \$50 to \$48. This represents a \$200 loss to the buyer, or 20% of the \$1,000 deposited as margin. Thus, leverage can either benefit or harm an investor.

Note that a 4% decrease in the value of the contract resulted in a loss of 20% of the margin deposited. A 20% decrease would wipe out 100% of the margin deposited on the security futures contract.

SECTION 5 – SETTLEMENT

If you do not liquidate your position prior to the end of trading on the last day before the expiration of the security futures contract, you are obligated to either 1) make or accept a cash payment ("cash settlement") or 2) deliver or accept delivery of the underlying securities in exchange for final payment of the final settlement price ("physical delivery"). The terms of the contract dictate whether it is settled through cash settlement or by physical delivery.

The expiration of a security futures contract is established by the exchange on which the contract is listed. On the expiration day, security futures contracts cease to exist. Typically, the last trading day of a security futures contract will be the third Friday of the expiring contract month, and the expiration day will be the following Saturday. This follows the expiration conventions for stock options and broad-based stock indexes. Please keep in mind that the expiration day is set by the listing exchange and may deviate from these norms.

5.1. CASH SETTLEMENT

In the case of cash settlement, no actual securities are delivered at the expiration of the security futures contract. Instead, you must settle any open positions in security futures by making or receiving a cash payment based on the difference between the final settlement price and the previous day's settlement price. Under normal circumstances, the final settlement price for a cash-settled contract will reflect the opening price for the underlying security. Once this payment is made, neither the buyer nor the seller of the security futures contract has any further obligations on the contract.

5.2. SETTLEMENT BY PHYSICAL DELIVERY

Settlement by physical delivery is carried out by clearing brokers or their agents with National Securities Clearing Corporation ("NSCC"), an SEC-regulated securities clearing agency. Such settlements are made in much the same way as they are for purchases and sales of the underlying security. Promptly after the last day of trading, the regulated exchange's clearing organization will report a purchase and sale of the underlying stock at the previous day's settlement price (also referred to as the "invoice price") to NSCC. If NSCC does not reject the transaction by a time specified in its rules, settlement is effected pursuant to the rules of NSCC within the normal clearance and settlement cycle for securities transactions, which currently is three business days.

If you hold a short position in a physically settled security futures contract to expiration, you will be required to make delivery of the underlying securities. If you already own the securities, you may tender them to your brokerage firm. If you do not own the securities, you will be obligated to purchase them. Some brokerage firms may not be able to purchase the securities for you. If your brokerage firm cannot purchase the underlying securities on your behalf to fulfill a settlement obligation, you will have to purchase the securities through a different firm.

SECTION 6 – CUSTOMER ACCOUNT PROTECTIONS

Positions in security futures contracts may be held either in a securities account or in a futures account. Your brokerage firm may or may not permit you to choose the types of account in which your positions in security futures contracts will be held. The protections for funds deposited or earned by customers in connection with trading in security futures contracts differ depending on whether the positions are carried in a securities account or a futures account. If your positions are carried in a securities account, you will not receive the protections available for futures accounts. Similarly, if your positions are carried in a futures account, you will not receive the protections available for securities accounts. You should ask your broker which of these protections will apply to your funds.

You should be aware that the regulatory protections applicable to your account are not intended to insure you against losses you may incur as a result of a decline or increase in the price of a security futures contract. As with all financial products, you are solely responsible for any market losses in your account.

Your brokerage firm must tell you whether your security futures positions will be held in a securities account or a futures account. If your brokerage firm gives you a choice, it must tell you what you have to do to make the choice and which type of account will be used if you fail to do so. You should understand that certain regulatory protections for your account will depend on whether it is a securities account or a futures account.

6.1. PROTECTIONS FOR SECURITIES ACCOUNTS

If your positions in security futures contracts are carried in a securities account, they are covered by SEC rules governing the safeguarding of customer funds and securities. These rules prohibit a broker/dealer from using customer funds and securities to finance its business. As a result, the broker/dealer is required to set aside funds equal to the net of all its excess payables to customers over receivables from customers. The rules also require a broker/dealer to segregate all customer fully paid and excess margin securities carried by the broker/dealer for customers.

The Securities Investor Protection Corporation (SIPC) also covers positions held in securities accounts. SIPC was created in 1970 as a non-profit, non-government, membership corporation, funded by member broker/dealers. Its primary role is to return funds and securities to customers if the broker/dealer holding these assets becomes insolvent. SIPC coverage applies to customers of current (and in some cases former) SIPC members. Most broker/dealers registered with the SEC are SIPC members; those few that are not must disclose this fact to their customers. SIPC members must display an official sign showing their membership. To check whether a firm is a SIPC member, go to www.sipc.org, call the SIPC Membership Department at (202) 371-8300, or write to SIPC Membership Department, Securities Investor Protection Corporation, 805 Fifteenth Street, NW, Suite 800, Washington, DC 20005-2215.

SIPC coverage is limited to $500,000 per customer, including up to $100,000 for cash. For example, if a customer has 1,000 shares of XYZ stock valued at $200,000 and $10,000 cash in the account, both the security and the cash balance would be protected. However, if the customer has shares of stock valued at $500,000 and $100,000 in cash, only a total of $500,000 of those assets will be protected.

For purposes of SIPC coverage, customers are persons who have securities or cash on deposit with a SIPC member for the purpose of, or as a result of, securities transactions. SIPC does not protect customer funds placed with a broker/dealer just to earn interest. Insiders of the broker/dealer, such as its owners, officers, and partners, are not customers for purposes of SIPC coverage.

6.2. PROTECTIONS FOR FUTURES ACCOUNTS

If your security futures positions are carried in a futures account, they must be segregated from the brokerage firm's own funds and cannot be borrowed or otherwise used for the firm's own purposes. If the funds are deposited with another entity (e.g., a bank, clearing broker, or clearing organization), that entity must acknowledge that the funds belong to customers and cannot be used to satisfy the firm's debts. Moreover, although a brokerage firm may carry funds belonging to different customers in the same bank or clearing account, it may not use the funds of one customer to margin or guarantee the transactions of another customer. As a result, the brokerage firm must add its own funds to its customers' segregated funds to cover customer debits and deficits. Brokerage firms must calculate their segregation requirements daily.

You may not be able to recover the full amount of any funds in your account if the brokerage firm becomes insolvent and has insufficient funds to cover its obligations to all of its customers. However, customers with funds in segregation receive priority in bankruptcy proceedings. Furthermore, all customers whose funds are required to be segregated have the same priority in bankruptcy, and there is no ceiling on the amount of funds that must be segregated for or can be recovered by a particular customer.

Your brokerage firm is also required to separately maintain funds invested in security futures contracts traded on a foreign exchange. However, these funds may not receive the same protections once they are transferred to a foreign entity (e.g., a foreign broker, exchange or clearing organization) to satisfy margin requirements for those products. You should ask your broker about the bankruptcy protections available in the country where the foreign exchange (or other entity holding the funds) is located.

SECTION 7 – SPECIAL RISKS FOR DAY TRADERS

Certain traders who pursue a day trading strategy may seek to use security futures contracts as part of their trading activity. Whether day trading in security futures contracts or other securities, investors engaging in a day trading strategy face a number of risks.

• *Day trading in security futures contracts requires in-depth knowledge of the securities and futures markets and of trading techniques and strategies.* In attempting to profit through day trading, you will compete with professional traders who are knowledgeable and sophisticated in these markets. You should have appropriate experience before engaging in day trading.

• *Day trading in security futures contracts can result in substantial commission charges, even if the per trade cost is low.* The more trades you make, the higher your total commissions will be. The total commissions you pay will add to your losses and reduce your profits. For instance, assuming that a round-turn trade costs $16 and you execute an average of 29 round-turn transactions per day each trading day, you would need to generate an annual profit of $111,360 just to cover your commission expenses.

• *Day trading can be extremely risky.* Day trading generally is not appropriate for someone of limited resources and limited investment or trading experience and low risk tolerance. You should be prepared to lose all of the funds that you use for day trading. In particular, you should not fund day trading activities with funds that you cannot afford to lose.

SECTION 8 – OTHER

8.1. CORPORATE EVENTS

As noted in Section 2.4, an equity security represents a fractional ownership interest in the issuer of that security. By contrast, the purchaser of a security futures contract has only a contract for future delivery of the underlying security. Treatment of dividends and other corporate events affecting the underlying security may be reflected in the security futures contract depending on the applicable clearing organization rules. Consequently, individuals should consider how dividends and other developments affecting security futures in which they transact will be handled by the relevant exchange and clearing organization. The specific adjustments to the terms of a security futures contract are governed by the rules of the applicable clearing organization. Below is a discussion of some of the more common types of adjustments that you may need to consider.

Corporate issuers occasionally announce stock splits. As a result of these splits, owners of the issuer's common stock may own more shares of the stock, or fewer shares in the case of a reverse stock split. The treatment of stock splits for persons owning a security futures contract may vary according to the terms of the security futures contract and the rules of the clearing organization. For example, the terms of the contract may provide for an adjustment in the number of contracts held by each party with a long or short position in a security future, or for an adjustment in the number of shares or units of the instrument underlying each contract, or both.

Corporate issuers also occasionally issue special dividends. A special dividend is an announced cash dividend payment outside the normal and customary practice of a corporation. The terms of a security futures contract may be adjusted for special dividends. The adjustments, if any, will be based upon the rules of the exchange and clearing organization. In general, there will be no adjustments for ordinary dividends as they are recognized as a normal and customary practice of an issuer and are already accounted for in the pricing of security futures.

Corporate issuers occasionally may be involved in mergers and acquisitions. Such events may cause the underlying security of a security futures contact to change over the contract duration. The terms of security futures contracts may also be adjusted to reflect other corporate events affecting the underlying security.

8.2. POSITION LIMITS AND LARGE TRADER REPORTING

All security futures contracts trading on regulated exchanges in the United States are subject to position limits or position accountability limits. Position limits restrict the number of security futures contracts that any one person or group of related persons may hold or control in a particular security futures contract. In contrast, position accountability limits permit the accumulation of positions in excess of the limit without a prior exemption. In general, position limits and position accountability limits are beyond the thresholds of most retail investors. Whether a security futures contract is subject to position limits, and the level for such limits, depends upon the trading activity and market capitalization of the underlying security of the security futures contract.

Position limits apply are required for security futures contracts that overlie a security that has an average daily trading volume of 20 million shares or fewer. In the case of a security futures contract overlying a security index, position limits are required if any one of the securities in the index has an average daily trading volume of 20 million shares or fewer. Position limits also apply only to an expiring security futures contract during its last five trading days. A regulated exchange must establish position limits on security futures that are no greater than 13,500 (100 share) contracts, unless the underlying security meets certain volume and shares outstanding thresholds, in which case the limit may be increased to 22,500 (100 share) contracts.

For security futures contracts overlying a security or securities with an average trading volume of more than 20 million shares, regulated exchanges may adopt position accountability rules. Under position accountability rules, a trader holding a position in a security futures contract that exceeds 22,500 contracts (or such lower limit established by an exchange) must agree to provide information regarding the position and consent to halt increasing that position if requested by the exchange.

Brokerage firms must also report large open positions held by one person (or by several persons acting together) to the CFTC as well as to the exchange on which the positions are held. The CFTC's reporting requirements are 1,000 contracts for security futures positions on individual equity securities and 200 contracts for positions on a narrow-based index. However, individual exchanges may require the reporting of large open positions at levels less than the levels required by the CFTC. In addition, brokerage firms must submit identifying information on the account holding the reportable position (on a form referred to as either an "Identification of Special Accounts Form" or a "Form 102") to the CFTC and to the exchange on which the reportable position exists within three business days of when a reportable position is first established.

8.3. TRANSACTIONS ON FOREIGN EXCHANGES

U.S. customers may not trade security futures on foreign exchanges until authorized by U.S. regulatory authorities. U.S. regulatory authorities do not regulate the activities of foreign exchanges and may not, on their own, compel enforcement of the rules of a foreign exchange or the laws of a foreign country. While U.S. law governs transactions in security futures contracts that are effected in the U.S., regardless of the exchange on which the contracts are listed, the laws and rules governing transactions on foreign exchanges vary depending on the country in which the exchange is located.

8.4. TAX CONSEQUENCES

For most taxpayers, security futures contracts are not treated like other futures contracts. Instead, the tax consequences of a security futures transaction depend on the status of the taxpayer and the type of position (e.g., long or short, covered or uncovered). Because of the importance of tax considerations to transactions in security futures, readers should consult their tax advisors as to the tax consequences of these transactions.

SECTION 9 – GLOSSARY OF TERMS

This Glossary is intended to assist customers in understanding specialized terms used in the futures and securities industries. It is not inclusive and is not intended to state or suggest the legal significance or meaning of any word or term.

Arbitrage – taking an economically opposite position in a security futures contract on another exchange, in an options contract, or in the underlying security.

Broad-based security index – a security index that does not fall within the statutory definition of a narrow-based security index (see Narrow-based security index). A future on a broad-based security index is not a security future. This risk disclosure statement applies solely to security futures and generally does not pertain to futures on a broad-based security index. Futures on a broad-based security index are under exclusive jurisdiction of the CFTC.

Cash settlement – a method of settling certain futures contracts by having the buyer (or long) pay the seller (or short) the cash value of the contract according to a procedure set by the exchange.

Clearing broker – a member of the clearing organization for the contract being traded. All trades, and the daily profits or losses from those trades, must go through a clearing broker.

Clearing organization – a regulated entity that is responsible for settling trades, collecting losses and distributing profits, and handling deliveries.

Contract – 1) the unit of trading for a particular futures contract (e.g., one contract may be 100 shares of the underlying security), 2) the type of future being traded (e.g., futures on ABC stock).

Contract month – the last month in which delivery is made against the futures contract or the contract is cash-settled. Sometimes referred to as the delivery month.

Day trading strategy – an overall trading strategy characterized by the regular transmission by a customer of intra-day orders to effect both purchase and sale transactions in the same security or securities.

EDGAR – the SEC's Electronic Data Gathering, Analysis, and Retrieval system maintains electronic copies of corporate information filed with the agency. EDGAR submissions may be accessed through the SEC's website, www.sec.gov.

Futures contract – a futures contract is (1) an agreement to purchase or sell a commodity for delivery in the future; (2) at a price determined at initiation of the contract; (3) that obligates each party to the contract to fulfill it at the specified price; (4) that is used to assume or shift risk; and (5) that may be satisfied by delivery or offset.

Hedging – the purchase or sale of a security future to reduce or offset the risk of a position in the underlying security or group of securities (or a close economic equivalent).

Illiquid market – a market (or contract) with few buyers and/or sellers. Illiquid markets have little trading activity and those trades that do occur may be done at large price increments.

Liquidation – entering into an offsetting transaction. Selling a contract that was previously purchased liquidates a futures position in exactly the same way that selling 100 shares of a particular stock liquidates an earlier purchase of the same stock. Similarly, a futures contract that was initially sold can be liquidated by an offsetting purchase.

Liquid market – a market (or contract) with numerous buyers and sellers trading at small price increments.

Long – 1) the buying side of an open futures contact, 2) a person who has bought futures contracts that are still open.

Margin – the amount of money that must be deposited by both buyers and sellers to ensure performance of the person's obligations under a futures contract. Margin on security futures contracts is a performance bond rather than a down payment for the underlying securities.

Mark-to-market – to debit or credit accounts daily to reflect that day's profits and losses.

Narrow-based security index – in general, and subject to certain exclusions, an index that has any one of the following four characteristics: (1) it has nine or fewer component securities; (2) any one of its component securities comprises more than 30% of its weighting; (3) the five highest weighted component securities together comprise more than 60% of its weighting; or (4) the lowest weighted component securities comprising, in the aggregate, 25% of the index's weighting have an aggregate dollar value of average daily trading volume of less than $50 million (or in the case of an index with 15 or more component securities, $30 million). A security index that is not narrow-based is a "broad based security index." (See Broad-based security index).

Nominal value – the face value of the futures contract, obtained by multiplying the contract price by the number of shares or units per contract. If XYZ stock index futures are trading at $50.25 and the contract is for 100 shares of XYZ stock, the nominal value of the futures contract would be $5025.00.

Offsetting – liquidating open positions by either selling fungible contracts in the same contract month as an open long position or buying fungible contracts in the same contract month as an open short position.

Open interest – the total number of open long (or short) contracts in a particular contract month.

Open position – a futures contract position that has neither been offset nor closed by cash settlement or physical delivery.

Performance bond – another way to describe margin payments for futures contracts, which are good faith deposits to ensure performance of a person's obligations under a futures contract rather than down payments for the underlying securities.

Physical delivery – the tender and receipt of the actual security underlying the security futures contract in exchange for payment of the final settlement price.

Position – a person's net long or short open contracts.

Regulated exchange – a registered national securities exchange, a national securities association registered under Section 15A(a) of the Securities Exchange Act of 1934, a designated contract market, a registered derivatives transaction execution facility, or an alternative trading system registered as a broker or dealer.

Security futures contract – a legally binding agreement between two parties to purchase or sell in the future a specific quantity of shares of a security (such as common stock, an exchange-traded fund, or ADR) or a narrow-based security index, at a specified price.

Settlement price – 1) the daily price that the clearing organization uses to mark open positions to market for determining profit and loss and margin calls, 2) the price at which open cash settlement contracts are settled on the last trading day and open physical delivery contracts are invoiced for delivery.

Short – 1) the selling side of an open futures contract, 2) a person who has sold futures contracts that are still open.

Speculating – buying and selling futures contracts with the hope of profiting from anticipated price movements.

Spread – 1) holding a long position in one futures contract and a short position in a related futures contract or contract month in order to profit from an anticipated change in the price relationship between the two, 2) the price difference between two contracts or contract months.

Stop limit order – an order that becomes a limit order when the market trades at a specified price. The order can only be filled at the stop limit price or better.

Stop loss order – an order that becomes a market order when the market trades at a specified price. The order will be filled at whatever price the market is trading at. Also called a stop order.

Tick – the smallest price change allowed in a particular contract.

Trader – a professional speculator who trades for his or her own account.

Underlying security – the instrument on which the security futures contract is based. This instrument can be an individual equity security (including common stock and certain exchange-traded funds and American Depositary Receipts) or a narrow-based index.

Volume – the number of contracts bought or sold during a specified period of time. This figure includes liquidating transactions.