

THE FUTURE OF THE COMMODITY FUTURES MARKET: HOW CUSTOMER SEGREGATED ACCOUNTS CAN BE BETTER PROTECTED FROM INSOLVENT FUTURES COMMISSION MERCHANTS

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Abstract

Two of the largest futures commission merchants (“FMCs”)—MF Global and Peregrine Financial Group—filed for bankruptcy in 2011 and 2012, respectively. The bankruptcies of two of the largest players in the futures commodity market shook up the industry. Many customers became weary and distrustful of FCMs. This Article proposes solutions in order to boost customer confidence in the futures market without deterring the largest futures traders. Further, this Article discusses the pitfalls of the current regulatory model with respect to customer segregated funds and the necessary changes to the current regime by the CFTC and other self-regulatory organizations. After the MF Global and Peregrine Financial bankruptcies, the CFTC and other self-regulatory organizations put forth additional requirements for increased protection of customer segregated funds held by FCMs. Solutions discussed in this Article include an industry funded insurance pool, the use of third party custodial accounts, a customer guaranty fund, and a central customer funds repository. This Article recommends a short term proposal of an optional customer guaranty fund and a long term proposal of a central customer funds repository.

I. Introduction

Daryl Larson, a cattle and wheat farmer from McPherson, Kansas, who utilizes the futures commodity market to sell his crops and to hedge the risk of commodity price fluctuation, sums up his confidence in the current futures market: “There’s basically three places, only, that I trust people in suits and that’s at church, weddings and funerals.”¹ Larson’s lack of trust in the futures market is

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1. Jeremy Bernfeld, *Markets Woo Wary Farmers*, HARVEST PUB. MEDIA (July 18, 2012, 8:33 AM), <http://harvestpublicmedia.org/article/1316/futures-markets-cme-group-woo-wary-farmers/5>; see Jeremy

not because of the year-long drought or the global economic downturn.² Instead, his lack of trust derives from a year when two of the most trusted futures commission merchants (“FCM”),³ MF Global Holdings Company (“MF Global”) and Peregrine Financial Group (“Peregrine Financial”), filed for bankruptcy in the midst of fraud, million/billion dollar losses, and vanishing customer segregated funds.⁴ In a market that depends on customer confidence, the futures commodity market is moving backwards.⁵ In the light of the bankruptcies of MF Global and Peregrine Financial, the futures commodity market must evaluate and implement certain regulatory and systematic structural changes to boost customer confidence in the market without deterring the largest futures traders. This Article provides an overview of viable options for the market to consider.

On October 31, 2011, MF Global filed for Chapter 11 bankruptcy protection.⁶ After this filing, regulators and court personnel found that legally customer segregated funds of MF Global had vanished.⁷ As the dust settled, it was reported that over \$1.6 billion legally customer segregated funds were not accounted for and could not be transferred to customers or other FCMs.⁸ Today, the MF Global bankruptcy proceedings are still ongoing, and bankruptcy trustee James Giddens is still trying to make customers whole.⁹ The MF Global debacle shook the futures industry because it was the first time that legally customer segregated funds could not be located by a defaulting FCM.¹⁰ The loss of customer segregated funds created much concern across the industry and in Congress.

Anxieties magnified exponentially nine months later when Peregrine Financial Group filed for Chapter 7 Bankruptcy protection on July 7, 2012.¹¹ The bankruptcy was a result of Peregrine Financial’s CEO Russell Wasendorf’s fraudulent misappropriations of legally customer segregated funds, and falsification of regulatory compliance documents with the Commodity Futures

Bernfeld, *After MF Global Crisis, Farmers May Hedge on Hedging*, HARVEST PUB. MEDIA (Jan. 3, 2012), <http://harvestpublicmedia.org/article/941/after-mf-global-crisis-farmers-may-hedge-hedging/5>.

2. See Bernfeld, *Markets Woo Wary Farmers*, *supra* note 1.

3. Futures commission merchants are “[i]ndividuals, associations, partnerships, corporations, and trusts that solicit or accept orders for the purchase or sale of any commodity for future delivery on or subject to the rules of any exchange and that accept payment from or extend credit to those whose orders are accepted.” Commodity Exchange Act, 7 U.S.C. § 1a(28) (2012).

4. *Id.*

5. Terrance Duffy, *A Year After MF Global Failure, Customers Safer Than Before Collapse*, FUTURES MAGAZINE (Oct. 30, 2012), <http://www.futuresmag.com/2012/10/30/a-tear-after-mf-global-failure-customers-safer-tha>. “For more than 160 years, no customer had ever lost a penny as the result of default by a futures industry clearing member. MF Global’s failure last October, followed by fraud at PFGBest nine months later, shattered this uninterrupted legacy of trust in our industry.” *Id.*

6. Voluntary Petition for Chpt. 11 Bankruptcy, *In re MF Global Holdings Ltd.*, No. 11-15059 (Bankr. S.D.N.Y. Oct. 31, 2011), *available at* http://mfglobalcaseinfo.com/pdflib/1_15059.pdf.

7. *Investigative Hearing on the MF Global Bankr.: Hearing Before the S. Comm. on Agric., Nutrition & Forestry*, 111th Cong. (2011) (opening statement of Chairwoman Debbie Stabenow), *available at* <http://www.ag.senate.gov/hearings/investigative-hearing-on-the-mf-global-bankruptcy>.

8. *Examining the Futures Mkts.: Responding to the Failure of MF Global & Peregrine Fin. Grp.: Hearing Before the S. Comm. on Agric., Nutrition & Forestry*, 112th Cong. (2012) (testimony by James Giddens, Trustee for Securities Investment Protection Act Liquidation of MF Global, Inc.), *available at* <http://www.ag.senate.gov/hearings/examining-the-futures-markets-responding-to-the-failures-of-mf-global-and-peregrine-financial-group>.

9. *See id.*

10. *See* Duffy, *supra* note 5.

11. Voluntary Petition for Chpt. 7 Bankruptcy, *In re Peregrine Fin. Grp., Inc.*, No. 12-27488 (Bankr. N.D. Ill. July 7, 2012), *available at* http://www.omningt.com/CMSVol/CMSDocs/pub_46535/318703_1.pdf.

Trading Commission (“CFTC”).¹² Following the bankruptcy of Peregrine Financial, the CFTC filed a civil lawsuit against Wasendorf and his company alleging the CEO had misappropriated more than \$200 million in customer funds.¹³ Wasendorf subsequently pled guilty to federal criminal charges of “making and using false statements [to] the Government of the United States” and to embezzling more than \$200 million of legally customer segregated funds.¹⁴

In the aftermath of these events in the futures commodity market, it is clear that customers who provide funds to FCMs are entitled to enhanced legal protection from potentially unlawful practices of FCMs.¹⁵ Thus, this Article considers the viability of an industry sponsored insurance fund for the futures commodity markets that would mimic the insurance fund provided for securities by the Securities Investor Protection Act (“SIPA”).¹⁶ With this type of insurance fund, a cost-benefit analysis is appropriate along with an examination of other options, as considered in Part IV. An implementation of an optional Guaranty Fund is a short-term solution that would provide immediate protection for customer segregated funds. In the long term, however, regulators need to implement a total segregation model, such as a Central Customer Funds Repository, an idea suggested by former CFTC Chairman Philip McBride Johnson.¹⁷

First, Part II offers a brief discussion of how the collapses of MF Global and Peregrine Financial led to a hearing in front of the U.S. Senate Committee on Agriculture, Nutrition, and Forestry (“Senate Committee”). Then, this Article outlines the current regime of FCM regulation and the self-regulatory model used by the futures market. In addition, this Article focuses on the failures of the regulatory model with respect to customer segregated funds, and the necessary regulatory changes that will need to be implemented by the CFTC and self-regulatory organizations (“SRO”).

Then, Part IV examines the viability of an industry sponsored insurance fund. Part IV studies the positives and negatives of the creation of such an insurance fund and the amount of congressional support necessary for the implementation of such a fund. Part V then contemplates the possible alternatives available other than an industry sponsored insurance fund. The conclusion recommends the creation of an optional Guaranty Fund as the best immediate solution for futures market participants and provides that regulators and Congress must consider a total segregation model such as the Central Customer Fund Repository for long term protection for customer segregated funds.

12. Complaint for Injunctive and Other Equitable Relief and Civil Monetary Penalties Under the Commodity Exchange Act, *CFTC v. Peregrine Fin. Grp., Inc.*, No. 1:12-cv-05383 (N.D. Ill. July 7, 2012), available at <http://www.cftc.gov/ucm/groups/public/@lrenforcementactions/documents/legalpleading/enfpfg-complaint071012.pdf>.

13. *Id.*

14. *Id.*

15. See *Examining the Futures Markets: Responding to the Failure of MF Global & Peregrine Fin. Grp.: Hearing Before the S. Comm. on Agric., Nutrition & Forestry*, 112th Cong. (Aug. 1, 2012) [hereinafter *Hearing on Futures Markets*] (testimony by Hon. Gary Gensler Chairman, CFTC), available at <http://www.ag.senate.gov/hearings/examining-the-futures-markets-responding-to-the-failures-of-mf-global-and-peregrine-financial-group>.

16. See Bart Chilton & John L. Roe, *Can an Insurance Fund Make the Once Sacred Segregated Account Safe Again?*, OPALESQUE (Sept. 3, 2012), http://www.opalesque.com/OFI1292/Can_an_Insurance_Fund_Make_the_Once_Sacred292.html.

17. Philip McBride Johnson, *A Central Customer Funds Repository: Fact Sheet*, at 1 (2012) (on file with author).

II. The Background and Impact of the Bankruptcies of MF Global Ltd. and Peregrine Financial Group

A. MF Global Profile

MF Global was a well-respected commodities and securities brokerage firm in the modern financial markets.¹⁸ MF Global was an FCM and a registered broker-dealer that, as a financial intermediary, held customers' cash accounts and collateral.¹⁹ The global company was active in "markets for commodities, fixed income securities, equities, and foreign exchanges."²⁰ Primarily, MF Global placed and held trades on behalf of customers and made trades with their own proprietary accounts.²¹ Along with trading as a registered FCM and broker-dealer, MF Global provided clearing and settlement services, market research services, and market commentary services for active market participants.²²

B. MF Global Bankruptcy

In 2005, the CFTC amended regulatory Rule 1.5, which allowed FCMs to invest legally segregated customer funds in riskier investments such as sovereign debt instruments. FCMs were only able to make these investments in sovereign debt if the sovereign government bonds maintained the highest credit rating from three of the leading credit agencies.²³ After John Corzine became the CEO of MF Global in March 2010, the FCM took on a more aggressive investment strategy for its proprietary investments.²⁴ This aggressive proprietary trading strategy leveraged MF Global's investments, and these leveraged investments included positions in sovereign debt.²⁵ The market as a whole became concerned that MF Global exposed itself to too much risk by holding leveraged positions in sovereign debt instruments.²⁶

Although the aggressive trading strategy of MF Global made investors concerned about the firm's profitability, it was not the sole cause of the bankruptcy. Corzine testified to the Senate Committee that the repurchase agreements²⁷ MF Global had entered into in connection with its sovereign debt

18. Voluntary Petition for Chpt. 11 Bankruptcy, *supra* note 6.

19. John L. Roe & James L. Koutoulas, *White Paper: Background, Impacts & Solutions to MF Global's Demise*, COMMODITY CUSTOMER COALITION (Dec. 1, 2011), <http://www.scribd.com/doc/74527661/CCC-MFGlobal-White-Paper-Revised-12-1-11>.

20. Voluntary Petition for Chpt. 11 Bankruptcy, *supra* note 6.

21. *See* Roe & Koutoulas, *supra* note 19.

22. Voluntary Petition for Chpt. 11 Bankruptcy, *supra* note 6.

23. *See* 17 C.F.R. § 1.25; R. Tamara de Silva, *MF Global's Missing Customer Funds and Its Implications on the Futures Industry*, TIMELY OBJECTIONS BLOG (Nov. 28, 2011), <http://www.timelyobjections.com/2011/11/mf-globals-missing-customer-funds-and-its-implications-on-the-futures-industry.html>; *Investigative Hearing on the MF Global Bankr.*, *supra* note 7 (testimony by Jill Sommers, Comm'r, CFTC).

24. *See* Roe & Koutoulas, *supra* note 19.

25. *Id.*

26. *Investigative Hearing on the MF Global Bankr.*, *supra* note 7 (testimony by Bradley Abelow, President & CFO, MF Global Holdings Ltd.) ("First, it appeared that by mid-October of this year the market had become increasingly concerned with the firm's exposure to European sovereign debt.")

27. "A form of short-term borrowing for dealers in government securities. The dealer sells the government securities to investors, usually on an overnight basis, and buys them back the following day."

investments did not display losses.²⁸ Corzine and other high-ranking officers of MF Global claimed that a cut in MF Global's credit rating by Moody's and Standard and Poor's was due to an adverse valuation adjustment against one of the firm's deferred tax assets²⁹ and that a poor earnings record doomed the company to bankruptcy.³⁰

Whatever the cause, on October 25, 2011, MF Global announced a quarterly loss of \$191.6 million.³¹ After this announcement, Corzine stated MF Global had done its best to unwind customer positions to avoid losses, and the firm sold a mass amount of commercial paper instruments and corporate securities to boost marketplace confidence.³² Yet, these last efforts were to no avail and MF Global filed for Chapter 11 bankruptcy protection on October 31, 2011.³³ At this time, Chicago Mercantile Exchange Clearing ("CME Clearing") and the Derivative Clearing Organizations ("DCO") handling trades on behalf of MF Global, liquidated the positions held by MF Global. When exchanges and SROs inquired about the loss, MF Global's management "could not account for many hundreds of millions of dollars" of customer funds held by the firm.³⁴ Thus, it was clear that there was a shortfall in segregated customer funds and MF Global's management did not know the extent of the deficit or where exactly the customer funds were.³⁵ In the midst of suffering losses in its investment positions, MF Global must have transferred customer segregated accounts to house accounts, which is a violation of the Commodity Exchange Act of 1967.³⁶

C. Peregrine Financial Company Profile

Peregrine Financial was a registered FCM who brokered and handled its clients' futures and options trades.³⁷ Peregrine Financial offered a wide range of products that included futures contracts, foreign exchange products, options, full brokerage services, precious metal trades, trader education, and direct online trading services.³⁸ For thirteen straight years, *Futures Magazine* had listed Peregrine Financial as "one of the nation's top 50 brokers" with assets of around

Definition of "Repurchase Agreement", INVESTOPEDIA, <http://www.investopedia.com/terms/r/repurchase-agreement.asp#axzz2C4PIE1Sv> (last visited Aug. 31, 2013).

28. *Id.*

29. A deferred tax asset is "an asset on a company's balance sheet that may be used to reduce any subsequent period's income tax expense." *Deferred Tax Assets*, INVESTOPEDIA, <http://www.investopedia.com/terms/d/deferredtaxasset.asp#axzz2B5JE8QM> (last visited Aug. 31, 2013).

30. *Investigative Hearing on the MF Global Bankr.*, *supra* note 7 (testimony by John Corzine, Former Chairman & CEO, MF Global Holdings Ltd.).

31. *Id.*

32. *Id.*

33. *Id.* (testimony by Bradley Abelow, President & COO, MF Global Holdings Ltd.).

34. *News Releases: CME Group Statement Regarding MF Global*, CME GRP. (Nov. 2, 2011), <http://cmegroup.mediaroom.com/index.php?s=43&item=3202&pagetemplate=article>; *Investigative Hearing on the MF Global Bankr.*, *supra* note 7 (testimony by John Corzine, Former Chairman & CEO, MF Global Holdings Ltd.).

35. *Id.*

36. *See Investigative Hearing on the MF Global Bankr.*, *supra* note 7 (testimony by Terrance Duffy, Exec. Chairman, CME Grp.).

37. *See* 7 U.S.C. § 1a(28) (2012); *see Business Entities Results*, IOWA SEC'Y OF STATE, [http://sos.iowa.gov/search/business/\(S\(4espczevlxnves55epdzle2d\)\)/results.aspx](http://sos.iowa.gov/search/business/(S(4espczevlxnves55epdzle2d))/results.aspx) (last visited Aug. 31, 2013).

38. *Welcome to PFGBest*, PFGBEST, <http://www.pfgbest.com/about/> (last visited Aug. 31, 2013).

\$500 million.³⁹ The FCM also provided technologies to assist and advance the execution of futures trades for the benefit of a wide range of customers.⁴⁰

D. Peregrine Financial Bankruptcy

In July 2012, the National Futures Association (“NFA”), one of the SROs of the futures market, conducted an audit of Peregrine Financial.⁴¹ A Peregrine’s financial regulatory report claimed Peregrine Financial held in excess of \$220 million in its customer segregated accounts; yet, the NFA audit found only \$5.1 million in customer segregated accounts.⁴² The NFA’s audit also revealed that the CEO of Peregrine Financial, Russell Wasendorf Sr., falsified bank records and regulatory filings.⁴³

Subsequent to these findings, the NFA and the CFTC filed a civil lawsuit against Peregrine Financial indicating that Wasendorf misappropriated customer funds since February 2010.⁴⁴ With the accusations of fraud and deceit swirling, Peregrine Financial filed for Chapter 7 Bankruptcy on July 10, 2012.⁴⁵

E. The Collapse of MF Global and Peregrine Financial and the Impact on the Commodity Futures Market

Initially, the collapse of MF Global was viewed as an isolated event that did not impact stability of the futures commodity market.⁴⁶ However, as more facts came to light and customers were told that more than \$1.6 billion customer funds were missing and unaccounted for, many market participants began to lose faith in the commodities futures market.⁴⁷ Nine months later, when Peregrine Financial filed for bankruptcy, many customers incurred a loss, some a second loss, in their customer segregated accounts.⁴⁸ The bankruptcy of Peregrine Financial and MF Global demonstrated that there was a systematic flaw in the regulatory structure of the commodity futures market and customer segregated funds were in need of a higher level of protection.⁴⁹

39. *Id.*

40. *Id.*

41. Complaint for Injunctive and Other Equitable Relief and Civil Monetary Penalties Under the Commodity Exchange Act, *supra* note 12.

42. *Id.*

43. *Id.*

44. *Id.*

45. Voluntary Petition for Chpt. 7 Bankruptcy, *supra* note 6.

46. *Id.* (“Some might conclude that the system failed because of this one instance when customers have been injured despite the prescribed system of segregation. Regulatory failures happen, unfortunately . . . a firm failed to comply with applicable rules, but that does not mean the segregation system is a failed system.”).

47. Marcy Nicholson & Frank Tang, *Insight—U.S. Commodity Markets Shrink After MF Global Failure*, REUTERS (Dec. 21, 2011, 10:23 PM), <http://uk.reuters.com/article/2011/12/21/uk-mfglobal-futures-idUKTRE7BK1E220111221?type=GCA-ForeignExchange> (“U.S. commodity markets have shrunk almost 9 percent since MF Global’s collapse as farmers, investors and traders close out positions, . . . that suggests there may be lasting effects from the industry’s most disruptive broker failure.”).

48. *Hearing on Futures Markets*, *supra* note 15 (testimony by Diana Klemme, Vice President & Dir. of the Grain Div., Grain Serv. Corp.).

49. Daniel Collins & Michael McFarlin, *PFGBest Mess Raises Systemic Issues for Futures Industry*, FUTURES MAGAZINE (July 10, 2012), <http://www.futuresmag.com/2012/07/10/pfgbest-mess-raises-systemic-issues-for-futures-in>.

F. The Hearing Before the Senate Committee on Agriculture, Nutrition and Forestry

On August 1, 2012, the Senate Committee held a hearing to discuss the progress of the MF Global and Peregrine Financial bankruptcies. The Senate Committee held this meeting because many of the customers who suffered losses from the above bankruptcies were agricultural farmers and cooperatives—the very constituents the Senate Committee is designed to work with—who use futures markets to hedge price risk by entering derivative contracts.⁵⁰ At the hearing, Senators were concerned with how the industry or Congress could provide more protection to customer funds that are legally segregated from the FCM's proprietary funds.⁵¹ Also, the Committee wanted to hear that the CFTC and industry leaders were in the process of creating ways to better protect customer funds.⁵²

Three different panels consisting of regulatory and industry leaders from the CFTC, the NFA, CME Group, the Futures Industry Association (“FIA”), and the Commodity Customer Coalition responded to questions from Congress on the changes considered for the futures market.⁵³ One of the main lines of inquiry by the Senate Committee members was the viability of an industry sponsored insurance fund that would indemnify customer losses when customer segregated funds were misappropriated by failing FCMs.⁵⁴ Other solutions and recommendations were discussed, but the focus of the hearing revolved around the idea of the creation of an insurance fund.⁵⁵

G. The CFTC Roundtable on the Protection of Customer Segregated Funds

The CFTC held a roundtable hearing on August 9, 2012 to discuss ways the commodity futures industry could more effectively protect customer segregated funds and restore confidence in the market.⁵⁶ In these deliberations, the industry-funded insurance idea was the main thrust of the debate, but other considerations included third party custodial accounts and a Customer Protection Guaranty fund.⁵⁷ Part IV considers these ideas more fully; however, a basic understanding of the current regulatory system of FCMs and customer segregated funds, as discussed below, is necessary to provide a framework for these alternatives.

50. *Hearing on Futures Markets, supra* note 15 (opening statements by Chairwoman Debbie Stabenow).

51. *Id.*

52. *Id.*

53. *Id.*

54. *See id.* (each panel member for the Hearing provided recommendations for more protections for customer segregated funds. Every member on the panel took a position on the idea of an industry sponsored insurance fund).

55. *Hearing on Futures Markets, supra* note 15 (opening statements by Chairwoman Debbie Stabenow).

56. *See generally CFTC Staff to Host a Public Roundtable to Discuss Additional Customer Protections, CFTC* (Aug. 9, 2012), *transcript available at* <http://www.cftc.gov/ucm/groups/public/@newsroom/documents/file/transcript080912.pdf>.

57. *See id.* at 234–321.

III. Regulation of FCMs and Their Customer Segregated Funds

A. Statutorily Mandated Customer Segregated Accounts

1. Commodity Exchange Act

The Commodity Exchange Act, as amended by the Dodd-Frank Wall Street Reform and Consumer Protection Act,⁵⁸ mandates that all customer funds⁵⁹ held by an FCM must be segregated from the proprietary funds of the FCM.⁶⁰ These customer funds “shall not be commingled with the [FCM’s own accounts] or used . . . to margin or guarantee the trades or contracts, or to secure or extend the credit of any customer . . . other than for” the customer who provided the funds to the FCM.⁶¹ The customer funds, however, may be commingled for convenience with other customer funds in the same account or accounts held within any third party bank, trust company, or clearing house organization.⁶² Thus, the Act clearly mandates that FCMs shall not commingle customer funds with proprietary funds.⁶³

2. CFTC Regulations

The CFTC also provides a regulatory scheme that requires customer funds to be segregated from the FCM’s proprietary funds.⁶⁴ The regulation states no person, clearing organization, or third party depository entity receiving customer segregated funds “may hold, dispose of or use any [customer] funds for” anyone other than the option or commodity customer.⁶⁵ Further, all customer segregated funds must be sequestered from the FCMs property or any other person, and third party depository entities must acknowledge that they are holding customer accounts on behalf of the FCMs.⁶⁶ Thus, the regulatory scheme goes to great lengths to reiterate the rule that customer funds shall be segregated from the proprietary funds of the FCM.

58. Pub. L. No. 111-203, H.R. 4173.

59. Customer funds are defined as “all money, securities, and property received by a futures commission merchant or by a clearing organization from, for, or on behalf of customers or options customers.” 17 C.F.R. § 1.3(gg) (2012).

60. See 7 U.S.C. § 6d(a)(2).

61. *Id.*

62. See *id.* On January 11, 2012, the CFTC approved final rules relating to the segregation model for Cleared Swaps which impacts the FCMs. See generally SHEARMAN & STERLING LLP, CLIENT PUBLICATION: CFTC ADOPTS FINAL RULES ON PROTECTION OF CLEARED SWAPS COLLATERAL (Feb. 1, 2012), <http://www.shearman.com/files/Publication/62be6e9da97041ba8c9fed2b61c8479c/Presentation/PublicationAttachment/27c6ca1e-2f90-41f7-b7d6-cbff6485eb94/CFTC-Adopts-Final-Rules-on-Protection-of-Cleared-Swaps-Customer-Collateral-DR-020112.pdf>. The CFTC adopted the Legal Segregation with Operational Commingling Model (LSOC Model) which “allows FCMs and DCOs to commingle the collateral of their cleared swaps customers in a segregated omnibus customer account pre-bankruptcy. However, FCMs and DCOs may not (i) commingle cleared swaps collateral with other property or collateral (including futures margin or property and collateral belonging to the FCM or DCO) or (ii) use the collateral of one cleared swaps customer for the benefit of any other customer.” *Id.*

63. See 7 U.S.C. § 6d(a)(2) (2012).

64. 17 C.F.R. § 1.20 (2012).

65. *Id.*

66. 17 C.F.R. §§ 1.20(a), (c) (2012).

Indeed, federal regulations require, with limited exception, that each registered FCM make regulatory filings at the close of business each month and at the close of each fiscal year to monitor customer segregated funds.⁶⁷ Independent accountants certify the CFTC Form 1-FR-FCM filings, then the SROs and the CFTC review the forms to observe the financial condition of each registered FCM.⁶⁸ Within Form 1-FR-FCM, the regulations mandate a “statement of segregation requirements and funds in segregation for customers trading on U.S. commodity exchanges and for customers’ dealer options accounts.”⁶⁹ In other words, FCMs are required by law to provide an accounting of all customer funds held in these segregated accounts to the CFTC.

FCMs must also account, “monitor, and compute their segregation requirements and customer funds on deposit in segregated accounts on a daily basis and maintain copies of these reports, commonly known as a ‘daily segregation computation.’”⁷⁰ The daily segregation computation must be calculated at the close of each business day by reviewing the following: “the total amount of customer funds on deposit in segregated accounts . . . the amount of customer funds required by the [CEA] and these regulations to be on deposit in segregated accounts . . . and the amount of the FCMs residual interest in customer funds.”⁷¹ The daily segregation computations must be kept by the FCM for five years, and the records shall be open to inspection by any representative of the CFTC or the Department of Justice.⁷²

In addition to the daily recordkeeping activities for customer segregated funds, the FCMs must also keep each commodity customer updated on the amount and activity of the customer segregated accounts.⁷³ FCMs must inform each customer on a monthly basis the contracts that are open for each customer, the net unrealized profits or losses on the open contracts, any customer funds carried with the [FCM], and the charges and credits realized on the customer accounts.⁷⁴ Clearly, the CFTC, by these mandatory regulations, makes it a priority to monitor the customer segregated funds held by FCMs.

3. Self-Regulatory Organizations

The SROs are the parties that receive the regulatory filings completed by the registered FCMs because the SROs are the frontline regulators of the futures market.⁷⁵ Accompanying the federal regulations, the SROs have their own internal requirements that designated FCMs must comply with.⁷⁶ The NFA and CME Group require that all FCMs follow the appropriate CFTC regulations

67. See 17 C.F.R. § 1.10(b) (2012).

68. See 17 C.F.R. §§ 1.10(a)(2)(i)(A)(1), (a)(3)(i) (2012).

69. 17 C.F.R. § 1.10(d)(v) (2012).

70. Complaint for Injunctive and Other Equitable Relief and Civil Monetary Penalties Under the Commodity Exchange Act, *supra* note 12; see 17 C.F.R. § 1.32 (2012).

71. 17 C.F.R. §§ 1.32(a)(1)–(3) (2012).

72. 17 C.F.R. § 1.31 (a)(1) (2012).

73. 17 C.F.R. § 1.33(a)(1) (2012).

74. 17 C.F.R. §§ 1.33(a)(1)(i–iii) (2012).

75. See 17 C.F.R. §§ 1.10(a)(2)(i)(A)(1), (a)(3)(i) (2012); *Hearing on Futures Markets*, *supra* note 15, at 2–3 (testimony by Comm’r Gary Gensler).

76. See *NFA Manual/Rules*, NAT’L FUTURES ASS’N (2012), <http://www.nfa.futures.org/nfaManual/NFAManualTOC.aspx?Section=7>; see *CME Rulebook*, CME GRP. (2012), <http://www.cmegroup.com/rulebook/CME/>.

regarding customer segregated funds, and that FCMs follow a DCO's rules when using customer funds to post margin for or on behalf of customers.⁷⁷

The NFA and CME Group further mandate that each member FCM must maintain written policies and procedures regarding the maintenance of the FCM's residual interest in its customer segregated funds accounts, as identified in CFTC Regulation 1.20.⁷⁸ The residual interest is a surplus fund provided by the FCM within its customer segregated accounts to ensure that the FCM can meet its obligations to all of its customers.⁷⁹ The FCM residual interest within customer segregated accounts is there to cover any customer account deficits until a delinquent customer remedies the account deficit.⁸⁰ Under the NFA rules, "no FCM may withdraw, transfer, or . . . disburse funds" from any "customer segregated fund account" that "exceed[s] 25% of the FCM's residual interest in customer segregated funds based upon the most current daily segregated funds calculation" unless the FCM's officers preapprove in writing the segregated funds disbursement that exceeds the twenty-five percent threshold, and the FCM provides written notice that informs its respective SRO of the disbursement.⁸¹

The SROs impose a reporting requirement on the FCMs in this compliance scheme.⁸² The NFA and CME Group must report financial and operational information on a monthly, biweekly, and daily basis.⁸³ The monthly filings ask FCMs "whether any depository used to hold customer segregated funds or foreign futures and foreign options customer secured amount funds during the month is an affiliate of the FCM" while the biweekly and daily filings ask for "the dollar amount of customer segregated funds" and "the identity of each depository holding customer segregated funds and the dollar amount held at each depository."⁸⁴ By having access to these filings, the SRO's are able to monitor and cross reference the amount of funds held in customer segregated accounts. The NFA assesses a \$1,000 fine against an FCM for each day the FCM fails to meet the deadlines for each separate filing.⁸⁵

Finally, CME Group's clearing house and other DCOs attempt to safeguard customer segregated accounts if an FCM defaults.⁸⁶ If an FCM defaults, CME's clearing group, CME Clearing Inc., will "transfer non-involved customer

77. See *NFA Manual: Section 16*, NAT'L FUTURES ASS'N (Sept. 2012), <http://www.nfa.futures.org/nfaManual/NFAManual.aspx?RuleID=SECTION%2016&Section=7>; *Chapter 9: Clearing Members. Sec. 971-Segregation, Secured and Sequestered Requirements*, CME GRP. 23 (2012), available at <http://www.cmegroup.com/rulebook/CME/I/9/9.pdf>.

78. See *NFA Manual: Section 16*, NAT'L FUTURES ASS'N (Sept. 2012), <http://www.nfa.futures.org/nfaManual/NFAManual.aspx?RuleID=SECTION%2016&Section=7>; *Chapter 9: Clearing Members*, *supra* note 77.

79. See *id.*

80. Securities Representing Investment of Customer Funds Held in Segregated Accounts by Futures Commission Merchants, 62 Fed. Reg. 42,398, 42,399 (Aug. 7, 1997) (to be codified at 17 C.F.R. 1.23, 1.25).

81. See *NFA Manual: Section 16(b)(i-ii)*, NAT'L FUTURES ASS'N (Sept. 2012), <http://www.nfa.futures.org/nfaManual/NFAManual.aspx?RuleID=SECTION%2016&Section=7>; see *Chapter 9: Clearing Members*, *supra* note 77, at 24.

82. See *NFA Manual: Section 16(d)(i-iv)*, NAT'L FUTURES ASS'N (Sept. 2012), <http://www.nfa.futures.org/nfaManual/NFAManual.aspx?RuleID=SECTION%2016&Section=7>; see *Chapter 9: Clearing Members*, *supra* note 78, at 23-24.

83. See *id.*

84. See *id.*

85. See *NFA Manual: Section 16(d)(v)*, NAT'L FUTURES ASS'N (Sept. 2012), <http://www.nfa.futures.org/nfaManual/NFAManual.aspx?RuleID=SECTION%2016&Section=7>.

86. See *CME Clearing Financial Safeguards*, CME GRP. 15 (2012), available at <http://www.cmegroup.com/clearing/files/financialsafeguards.pdf>.

segregated positions and collateral” to other member FCMs of the clearing organization.⁸⁷ CME Clearing will then “liquidate [the] involved customer segregated . . . positions” and any FCM proprietary positions at the time of the default.⁸⁸ A defaulting FCM’s margin deposits, residual interest in customer segregated funds, and any other assets available from the FCM will be applied to the defaulting FCM’s failed trading obligations.⁸⁹

The problem with an FCM default with regards to customer segregated accounts is as follows: a customer segregated account is not provided “complete protection if an FCM’s default to CME Clearing results from a shortfall in customer segregated funds.”⁹⁰ CME Group explains, “If a default [by an FCM] to CME Clearing occurred in the FCM’s customer segregated . . . accounts, CME Clearing has the right to apply toward the default all [margin] deposits and positions within the respective account at CME Clearing.”⁹¹ Thus, innocent customers who did not cause the default are at risk of losing their position and margin deposits if there is a default of an FCM customer using the same clearing house (i.e., CME Clearing).⁹² In summary, SROs, specifically CME Group, provide safeguards to customer segregated accounts in the case of an FCM default.⁹³ However, a default of an FCM caused by a shortfall in customer segregated accounts still threatens a risk of loss to non-involved customers of the failing FCM.⁹⁴ In short, this is called Fellow Customer Risk. Fellow Customer Risk is “the risk that margin posted by one customer of an FCM will be used to cover a loss caused by a different customer of that FCM in the event of the failure of the FCM.”⁹⁵

B. The Failure of the Regulatory System in *MF Global* and *Peregrine Financial*

In the wake of the bankruptcies of MF Global and Peregrine Financial, it became clear that the regulatory system for customer segregated funds, as described above, failed to protect the interests of FCM customers.⁹⁶ The futures market will thrive only if customers have confidence that their funds are safe in the event of an FCM default.⁹⁷ Thus, it is imperative that Congress, the CFTC, and the SROs work together to establish a regulatory framework that restores confidence to the futures market.⁹⁸ The CFTC and the SROs have taken steps to update and strengthen the regulatory system after the bankruptcies of MF Global and Peregrine Financial.

87. *Id.*

88. *Id.*

89. *Id.*

90. *Id.* at 10.

91. *Id.* at 16.

92. *Id.*

93. *See id.* at 15–16.

94. *See id.*

95. *Hearing on Futures Markets*, *supra* note 15, at 5–6 (testimony by Comm’r Gary Gensler); *see generally* SHEARMAN & STERLING LLP, *supra* note 62.

96. *See* Collins & McFarlin, *supra* note 49.

97. *See id.* *see Hearing on Futures Markets*, *supra* note 15, at 2 (testimony by Dan Roth, President & CEO, Nat’l Futures Ass’n) (“For our markets to thrive, customers must know that their funds are safe.”).

98. *See Hearing on Futures Markets*, *supra* note 15, at 5–6 (testimony by Comm’r Gary Gensler).

C. Recently Implemented Changes to Regulatory Compliance

1. *Post-MF Global and Peregrine Financial Regulatory Changes by CFTC*

Since the collapse of MF Global and Peregrine Financial, the CFTC has made many changes to the regulatory system for the futures market, starting with Rule 1.25.⁹⁹ Rule 1.25 concerns the investment of customer segregated funds by restricting how FCMs can invest customer segregated funds.¹⁰⁰ Under the former Rule 1.25, the CFTC substantially expanded the list of acceptable, and riskier, investments for customer segregated funds.¹⁰¹ Many commentators believe this is what led to the collapse of MF Global.¹⁰² In response to MF Global's collapse, the CFTC amended Rule 1.25 to retract the expansive amendments that occurred between 2000 and 2005 while re-establishing a more customer sensitive regime by only allowing FCMs to invest customer segregated funds in low risk, low-volume investments such as U.S. government securities, municipal securities, commercial paper, corporate notes or bonds, and money market mutual funds.¹⁰³ More specifically, the amendments prohibited FCMs to invest in high risk securities like foreign sovereign debt.¹⁰⁴

Second, the CFTC mandated that clearing houses collect margin on a gross basis while denying FCMs the ability to offset one customer's collateral with another customer's collateral.¹⁰⁵ FCMs will not be able to send just the net required margin to the clearing house.¹⁰⁶ Instead, the DCO will collect margin and transmit on a gross basis.¹⁰⁷ For example, the old model would allow an FCM to post *net* initial margin, which is the difference between its total long and short positions on a given reference commodity. If an FCM had eighty short positions and 100 long positions, the FCM would only have to post initial margin to the DCO for the twenty positions not covered. Now, however, the FCM must post initial margin to the DCO for every position held as if every customer was a member of the DCO. So, the FCM would have to post initial *gross* margin for all 180 positions to the DCO.

In addition to this new margin requirement, the CFTC added more customer protection for cleared swap participants with the implementation of the legal segregation with operational comingling rule ("LSOC Rule").¹⁰⁸ The LSOC Rule provides protection to individual customers at the clearing house level of the

99. *Speeches & Testimony- Statement of Support: Enhancements for the Protection of Customers and Customer Funds*, CFTC (Oct. 23, 2012), <http://www.cftc.gov/PressRoom/SpeechesTestimony/genklerstatement102312>.

100. *See* 17 C.F.R. 1.25; *see Press Release: Customer Funds Investment Rules*, FUTURES MAGAZINE (Dec. 27, 2011), <http://www.futuresmag.com/2011/12/27/customer-funds-investment-rules>.

101. *See Hearing on Futures Markets*, *supra* note 15, at 5–6 (testimony by Comm'r Gary Gensler); *see Press Release*, *supra* note 100.

102. *Id.*

103. *See Investment of Customer Funds and Funds Held in Account for Foreign Futures and Foreign Options Transactions: Final Rule*, CFTC 11 (Dec. 5, 2011), *available at* <http://www.cftc.gov/ucm/groups/public/@newsroom/documents/file/federalregister120511a.pdf>.

104. *See id.*

105. *Hearing on Futures Markets*, *supra* note 15, at 5–6 (testimony by Comm'r Gary Gensler).

106. *Id.*; *Speeches & Testimony*, *supra* note 99.

107. *Id.*

108. *Hearing on Futures Markets*, *supra* note 15, at 5–6 (testimony by Comm'r Gary Gensler); *see supra* note 91 and accompanying text.

futures markets by reducing Fellow Customer Risk.¹⁰⁹ The LSOC Rule has not been extended to benefit futures customers or futures transactions; however, CFTC Chairman Gary Gensler indicated an interest in further consideration of the LSOC Rule's application to the futures market."¹¹⁰ The CFTC conducted a roundtable on the topic in February 2012, but no formal action has been taken by the CFTC.¹¹¹

Lastly, the CFTC has recently implemented on the federal level many of the requirements that are already required by the NFA.¹¹² By incorporating some of the NFA's compliance structure, the CFTC directs FCMs to "maintain written policies and procedures governing the maintenance of excess funds in customer segregated accounts."¹¹³ As with the SRO rules, this new regulatory requirement requires a written pre-approval by senior management of the FCM and disclosure to the SROs and the CFTC when the FCM has withdrawn more than twenty-five percent of the customer segregated accounts.¹¹⁴ The CFTC also adopted the SRO rule that an FCM must make a daily computation of customer segregated funds and the FCM must also report bimonthly figures of cash deposits and investments of customer funds to the SROs and the CFTC.¹¹⁵ Thus, the CFTC reinforced the importance that FCMs have a proprietary surplus fund that accompanies customer segregated funds and ensures customers obligations.

2. Recent SRO Rule Changes

The CFTC was not the only one that made changes to its regulatory regime after the collapses of MF Global and Peregrine Financial.¹¹⁶ After these events, the SROs came together to provide more protection to customer segregated funds. On March 12, 2012 a special committee ("SRO Committee") came together to make recommendations on how to better segregate and protect customer funds.¹¹⁷ The SRO Committee included the NFA, CME Group, and representatives from the other commodity exchanges, such as ICE, Kansas City Board of Trade, and Minneapolis Grain Exchanges.¹¹⁸ The SRO Committee established four compliance rule changes, which have been adopted by each SRO.¹¹⁹

109. *Hearing on Futures Markets*, *supra* note 15, at 5–6 (testimony by Comm'r Gary Gensler); *see generally* SHEARMAN & STERLING LLP, *supra* note 62.

110. *CFTC Adopts Final Rule on Protection of Cleared Swap Customer Collateral*, DAVIS POLK & WARDWELL 4 (Jan. 23, 2012), *available at* http://www.davispolk.com/files/Publication/c6a0afbb-08ab-4633-b42e-22747253969b/Presentation/PublicationAttachment/251babfe-a89a-4cf2-b01e-25566e38c435/012312_LSOC.pdf.

111. *Public Roundtable*, CFTC 4-4-40 (Feb. 29, 2012), *available at* <http://www.cftc.gov/ucm/groups/public/@newsroom/documents/file/transcript022912am.pdf>.

112. *Hearing on Futures Markets*, *supra* note 15, at 5–6 (testimony by Comm'r Gary Gensler).

113. *Id.*

114. *See id.*

115. *See id.*

116. *Hearing on Futures Markets*, *supra* note 15, at 1–2 (testimony by Dan Roth, President & CEO, Nat'l Futures Ass'n); *Hearing on Futures Markets*, *supra* note 15, at 2–3 (testimony by Terrance Duffy, President & CEO, CME Grp.).

117. *Id.*

118. *Id.*

119. *Id.* at 1–2 (testimony by Terrance Duffy, President & CEO, CME Grp.).

The first compliance rule change requires FCMs to file daily segregation reports with their SROs.¹²⁰ Second, FCMs must also file bimonthly Segregation Investment Detail Reports (“SIDR”), which must reflect “how customer segregated funds are invested and where those funds are held.”¹²¹ Third, since December 2011, SROs conducted more frequent spot checks on FCMs to monitor compliance with segregation requirements.¹²² Finally, all the SROs, and now the CFTC, have implemented a rule that requires top executives to pre-approve disbursements from customer segregated accounts that exceed the twenty-five percent residual interest of the FCM’s proprietary funds held in customer segregated accounts.¹²³ Any involved SRO “must be immediately notified of this pre-approval.”¹²⁴

3. Proposals by the CFTC and SROs to Provide More Protection to Customer Segregated Funds

In addition to the recent changes that were actually implemented in the regulatory scheme, the CFTC and the SROs also have made a few more proposed changes outside the rulemaking process on how to protect customer segregated funds.¹²⁵ In a collaborative effort, the CFTC and the SROs have worked together to provide more protection to customer segregated funds.¹²⁶

The first proposal is the creation of a direct electronic and online access view of an FCM’s bank and custodial accounts housing customer funds, which would allow the regulators to view an FCM’s customer accounts without the FCM’s knowledge or approval.¹²⁷ The SROs have backed this proposal because it would allow the SROs to cross-check any customer segregated account balance with the FCM’s daily segregation report.¹²⁸

A second proposal involves the implementation of more internal controls on FCMs regarding customer segregated accounts.¹²⁹ The Futures Industry Association (“FIA”) and the CFTC recommend controls that require FCMs to separate compliance duties among employees responsible with protecting customer funds.¹³⁰ Additional written procedures include policies for securities valuation in customer segregated accounts or custodial accounts and selection of banks, custodians and other depositories.¹³¹ Lastly, the recommendations require that the FCM have procedures to appropriately maintain and withdraw its residual interest held in the customer segregated funds.¹³²

120. *Id.*

121. *Id.*

122. *Id.*

123. *Id.*

124. *Id.*

125. *Id.*

126. *Id.*

127. *Id.*

128. *Hearing on Futures Markets, supra* note 15, at 1–2 (testimony by Dan Roth, President & CEO, Nat’l Futures Ass’n); *Hearing on Futures Markets, supra* note 15, at 2–3 (testimony by Terrance Duffy, President & CEO, CME Grp.).

129. *See Speeches & Testimony, supra* note 99; *Hearing on Futures Markets, supra* note 15, 1–2 (testimony by Terrance Duffy, President & CEO, CME Grp.).

130. *Hearing on Futures Markets, supra* note 15, 1–2 (testimony by Terrance Duffy, President & CEO, CME Grp.); *see Speeches & Testimony, supra* note 99.

131. *Id.*

132. *Id.*

A third proposal strengthens the current audit requirements that raise the level of scrutiny provided by independent public accountants.¹³³ Accompanying these auditing requirements, the CFTC and the SROs would like to implement rules that would require FCMs to ensure FCMs have adequate funds to cover potential margin deficits.¹³⁴

The fourth proposal is that the CFTC and the SROs implement a warning system that will alert the regulators when “an FCM’s funds are insufficient to meet the targeted residual interest in customer segregated accounts” or when there is a material change in an FCM’s creditworthiness or clearing arrangements.¹³⁵ A potential warning tool for regulators would be liquidity and capital requirements imposed upon FCMs.¹³⁶ If an FCM deviated from the standard, regulators would then be in a position to identify distressed FCMs.¹³⁷

The SROs also propose an e-confirmation system.¹³⁸ The e-confirmation system is where the SROs confirm the amount of customer segregated accounts within a bank or other depository institution that is holding an FCM’s customer segregated funds.¹³⁹ This will provide for an immediate confirmation by an online tool that would make the process smooth and efficient.¹⁴⁰ The e-confirmation tool would allow SROs to audit each FCM to verify bimonthly Segregation Investment Detail Reports and to verify the daily segregation statements.¹⁴¹

The above proposals and recent regulatory changes to the futures market seem like a good start to providing more protection to customer segregated funds; yet, the regulatory and compliance changes do not remedy the concern that FCM’s will mishandle customer segregated funds. In particular, where an individual or company blatantly disregards the regulatory framework and files fraudulent information, as with Peregrine Financial and MF Global, the new changes are insufficient to provide protection of customer segregated funds. It is no stretch to conclude the futures market was severely shaken by the recent collapses of MF Global and Peregrine Financial. Thus, more dramatic measures might be considered so that customers will feel safe in investing in the futures market. The following part highlights some of the more innovative solutions considered by the industry and Congress.

IV. An Industry Funded Insurance Pool and Market Alternatives

Concerned that more regulation was not a complete solution to the protection of customer segregated funds, members of the CFTC and the industry began to weigh options that could bring more protection to these accounts. First, CFTC Commissioner Bart Chilton would create an industry funded insurance pool. The industry considered the use of third party custodial accounts and a

133. *See Speeches & Testimony, supra* note 99.

134. *Id.*

135. *Id.*

136. *Id.*

137. *Id.*

138. *Hearing on Futures Markets, supra* note 15, at 1–2 (testimony by Dan Roth, President & CEO, Nat’l Futures Ass’n); *Hearing on Futures Markets, supra* note 15, at 2–3 (testimony by Terrance Duffy, President & CEO, CME Grp.).

139. *Id.*

140. *See id.*

141. *Id.* at 1–2 (testimony by Terrance Duffy, President & CEO, CME Grp.).

Customer Guaranty Fund. Finally, a former chairman of the CFTC has provided a framework of a Central Customer Funds Repository. Each of these alternatives is discussed below.

A. Commissioner Chilton's Insurance Fund Proposal

CFTC Commissioner Chilton observed that many of the futures customers who suffered losses from the collapse of MF Global were still not made whole while the company's security customers were quickly and efficiently provided payouts by the Securities Investor Protection Corporation ("SIPC").¹⁴² Commissioner Chilton reasoned that the creation of a similar fund for commodities futures customers is viable and he has provided a proposal of a Futures Investor and Customer Protection Act ("FICPA"), which would basically extend the SIPC protections to futures customers.¹⁴³ Chilton believes that this kind of insurance protection would provide a solution for futures customers if an FCM filed for bankruptcy in the face of a collapse.¹⁴⁴

Under his FICPA proposal, an initial fund would be created by assessing a fee on every FCM's previous year gross revenue from futures.¹⁴⁵ The fee assessed would be no more than one-half percent of the FCM's futures-specific gross revenue.¹⁴⁶ Chilton's plan would provide a pre-determined target level for the fund that would never exceed \$2.5 billion, and once this level was reached, the Futures Investor and Customer Protection Corporation ("FICPC"), a congressionally created corporation, could lower or suspend the premium collections.¹⁴⁷ Also, Chilton said that this plan would establish discounts on the fee assessment for revenues generated from commercial hedging or end-user customers.¹⁴⁸ This discount would encourage customers to use the futures market for commercial purposes.¹⁴⁹ In essence, FICPC would mimic SIPC.¹⁵⁰

Commissioner Chilton's proposal is the first concrete proposal for an industry sponsored insurance fund for customer segregated funds.¹⁵¹ The U.S. Senate Committee on Agriculture, Nutrition and Forestry first considered the insurance fund idea at a hearing held on August 1, 2012.¹⁵² Also, many industry leaders have considered the idea.¹⁵³ Some market participants support the proposal while others believe the creation of an insurance fund is cost

142. See Chilton & Roe, *supra* note 16; see also Bart Chilton, *Futures Investor and Customer Protection Act ("FICPA") Proposal*, CFTC (2012), available at <http://commoditycustomercoalition.org/wp-content/uploads/2012/08/FICPA-3-Point-Proposal-PDF-2.pdf>.

143. See Chilton & Roe, *supra* note 16.

144. *Id.*

145. *Id.*

146. *Id.*

147. See *id.*

148. See *id.*

149. *Id.*

150. See *id.*

151. See Philip McBride Johnson, *Is Insurance the Answer?*, FUTURES & OPTIONS WORLD (Aug. 21, 2012), <http://www.fow.com/Article/3078030/Johnson-Is-insurance-the-answer.html>; see Alanna Byrne, *Futures Insurance Fund Idea Gains Momentum*, FUTURES MAGAZINE (Aug. 10, 2012), <http://www.futuresmag.com/2012/08/10/futures-insurance-fund-idea-gains-momentum>.

152. *Hearing on Futures Markets*, *supra* note 15.

153. *Public Roundtable on Customer Protection Requirements*, CFTC 234-321 (Aug. 9, 2012), available at <http://www.cftc.gov/ucm/groups/public/@newsroom/documents/file/transcript080912.pdf>.

prohibitive.¹⁵⁴ Below are the positives and negatives associated with the creation of an industry sponsored insurance fund for customer segregated accounts.

1. Positives of an Industry Sponsored Insurance Fund

As Dan Roth, President of the NFA, has made clear, the futures markets can only thrive if customers have confidence that their funds are safe.¹⁵⁵ Thus, a market that is dependent on customer confidence needs a mechanism that provides adequate assurance to customers that their monies will be safe from FCM fraud and FCM failure.¹⁵⁶ One of the few mechanisms that can provide complete safety for customers in this market would be the creation of an insurance fund.¹⁵⁷ The positive effects of the creation of an industry sponsored insurance fund are explained below.

First and most important, an insurance fund will guarantee at least some return of customer funds in the face of an FCM bankruptcy.¹⁵⁸ MF Global's bankruptcy trustee, James Giddens, stated that eighty percent of its "security customers have received nearly the entirety of their account balances because of the [SIPC] advances," and the disbursements are still ongoing.¹⁵⁹ In comparison, the majority of MF Global's futures customers collected eighty percent of their customer segregated funds at the end of 2012. As such, the securities customers of MF Global had a mechanism—SIPC—to quickly restore its customer accounts while the futures customers had to wait for the bankruptcy process to run its course.¹⁶⁰

Second, the insurance fund would return confidence to the market following the MF Global and Peregrine Financial bankruptcies.¹⁶¹ An insurance fund is one of the few solutions that could alleviate customer concerns when an FCM becomes insolvent.¹⁶² According to Roth, customers will continue to utilize the futures markets in high volumes if they know that their funds will be protected by an insurance system.¹⁶³

Third, an insurance fund would mitigate losses from the fraudulent actions of FCMs.¹⁶⁴ In legal markets, such as the futures market, there will always be

154. *Id.* see *Hearing on Futures Markets*, *supra* note 15, at 3 (testimony by Terrance Duffy, President & CEO, CME Grp.).

155. *Hearing on Futures Markets*, *supra* note 15, at 2 (testimony by Dan Roth, President & CEO of Nat'l Futures Ass'n).

156. *See id.*

157. *See* Chilton & Roe, *supra* note 16; *Hearing on Futures Markets*, *supra* note 15, at 1–2 (testimony by John Roe, Co-Founder, Commodity Customer Coalition).

158. *See* Chilton & Roe, *supra* note 16.

159. *Hearing on Futures Markets*, *supra* note 15, at 1–2 (testimony by James Giddens, Trustee, Sec. Investor Prot. Act Liquidation of MF Global Inc.).

160. *See id.* at 1.

161. *Hearing on Futures Markets*, *supra* note 15, at 3 (testimony by Terrance Duffy, President & CEO, CME Grp.) ("An industry-funded insurance program covering fraud and failure . . . would certainly boost confidence but needs to be balanced against known negatives."); *see* Byrne, *supra* note 151; *see* Johnson, *supra* note 151.

162. *See* Collins & McFarlin, *supra* note 49.

163. *See id.*

164. *Hearing on Futures Markets*, *supra* note 15, at 1–2 (testimony by John Roe, Co-Founder, Commodity Customer Coalition). "The only mechanism which can mitigate the impact of fraudsters is account insurance." *Id.*

wrongdoers that avoid being discovered for a time.¹⁶⁵ Increased regulatory protections are necessary, but not every fraud in the market will be discovered quickly.¹⁶⁶ As a result, no matter how solid the regulatory scheme, there is always room for someone to engage in fraudulent acts at the expense of customers.¹⁶⁷ Consequently, customers need, and many want, an insurance fund as a safety net to protect themselves from wrongdoers in the futures market.¹⁶⁸

2. Drawbacks of Industry Sponsored Insurance Fund

An industry sponsored insurance fund, like all insurance funds, has unavoidable costs associated with its creation, leading many participants and leaders of the futures market to believe the creation of such is not justified.¹⁶⁹ There are three major drawbacks: (i) an insurance fund creates a moral hazard; (ii) an insurance fund creates additional costs for all market participants; and (iii) an insurance fund is typically capped at amounts that are insufficient to suffice fears of loss in large customer segregated accounts. These drawbacks are outlined below.

First, the creation of an insurance fund for the futures market will create a moral hazard for FCM customers. Indeed, customers will not perform adequate due diligence when selecting an FCM because the insurance fund protects them.¹⁷⁰ If FCMs are not selected based upon stability, they could then have an added incentive to enter into riskier trades with their proprietary funds.¹⁷¹ According to this argument, the creation of an insurance program “does nothing to reduce the risks of customer funds being mishandled by FCMs.”¹⁷² But the moral hazard concern is inherent in most forms of insurance.¹⁷³

A second concern with an industry sponsored insurance fund is that the initial insurance fund costs will be spread to all futures market participants.¹⁷⁴ For example, under Commissioner Chilton’s plan, each FCM will have to contribute one-half percent of their futures revenues to the creation of the initial insurance fund.¹⁷⁵ It is likely that these fees will be passed through to the FCMs’ customers.¹⁷⁶ Higher transaction costs for market participants, especially commercial hedgers and other market participants who use the futures market to hedge commercial risks, could create an incentive for these market participants to

165. *See id.*

166. *Id.* at 1–2, 4.

167. *See id.*

168. *See id.*; *see* Chilton & Roe, *supra* note 16.

169. *See Hearing on Futures Markets*, *supra* note 15, at 3 (testimony by Terrance Duffy, President & CEO, CME Grp.); *see* Collins & McFarlin, *supra* note 49.

170. *See* Byrne, *supra* note 151; Philip McBride Johnson, *Former CFTC Head Offers MF Global Solution*, *FUTURES MAGAZINE* (Jan. 1, 2012), <http://www.futuresmag.com/2012/01/01/former-cftc-head-offers-mf-global-solution>.

171. *See* Byrne, *supra* note 151; *see* Johnson, *supra* note 170.

172. E-Mail Interview with Philip McBride Johnson, Former Comm’r, CFTC (Sept. 16, 2012, 9:50 AM) (on file with author).

173. Tom Baker, *On the Genealogy of Moral Hazard*, 75 *TEX. L. REV.* 237, 239 (1996); Rebecca Duffy, *Note: The Moral Hazard of Increased Deposit Insurance: What the 1980s Savings and Loan Crisis Can Teach Us About Responding to the Current Financial Crisis*, 59 *DRAKE L. REV.* 559, 566 (2011); *see* Chilton & Roe, *supra* note 16.

174. *See* Byrne, *supra* note 151; Johnson, *supra* note 170.

175. *See* Chilton & Roe, *supra* note 16.

176. *See* Johnson, *supra* note 176.

seek other markets, such as swap markets or forward contracts, to fulfill their commercial needs.¹⁷⁷ Thus, the costs involved in raising the appropriate insurance fund could deter market participation by some of the most important futures customers.¹⁷⁸

The third drawback associated with an industry sponsored insurance fund is that insurance plans instituted in capital markets, such as the Federal Deposit Insurance Corporation, have caps on the amounts collected by any one customer.¹⁷⁹ Indeed, Commissioner Chilton's proposal caps the amount of recovery from the FICPA insurance fund for any customer at \$250,000.¹⁸⁰ Such a cap will create anxiety in large traders who post millions of dollars as margin for their commodity trades because they will be undeniably under-insured.¹⁸¹ Thus, the caps on recovery compared with the costs incurred in creating the initial fund might cause the industry's largest and most lucrative traders to leave the commodities futures market for the private swaps markets, the private forward contracts markets or some other investment choice.¹⁸² The futures exchanges would not want these large traders to leave the market.¹⁸³

B. Third Party Custodial Accounts

The drawbacks of an industry sponsored insurance fund warrant contemplating other alternatives to protect customer segregated funds starting with a system based on third party custodial accounts. A third party custodial account is where a futures customer posts his or her margin to a third party safekeeping account held at a custodial bank rather than posting margin directly to the FCM.¹⁸⁴ A third party custodial account would work as follows:

[W]hen a position is put on by a customer and a . . . call is made by the clearing house to that customer's FCM . . . the FCM [will satisfy] the margin call to the clearing house. . . . And the customer will post to a Tri-party account the same amount or excess amounts of margin to be held within that custody account, which is opened in the name of the FCM on behalf of the client in lieu of posting the margin directly to the FCM.¹⁸⁵

Under the current regulatory scheme, third party custodial accounts are prohibited by the CFTC,¹⁸⁶ but this could be easily fixed by amending an earlier CFTC interpretation ruling that prohibited third party custodial accounts for futures margins.¹⁸⁷ Custodial accounts would provide a high level of protection to

177. *See id.*; E-Mail Interview with Johnson, *supra* note 172.

178. *See id.*

179. E-Mail Interview with Johnson, *supra* note 172; *see* Byrne, *supra* note 151.

180. *See* Chilton & Roe, *supra* note 16.

181. E-Mail Interview with Johnson, *supra* note 172.

182. *See id.*

183. *See id.*

184. *Public Roundtable on Customer Protection Requirements*, CFTC 246 (Aug. 9, 2012), available at <http://www.cftc.gov/ucm/groups/public/@newsroom/documents/file/transcript080912.pdf>.

185. *Id.*

186. James L. Carley, *Amendment of Interpretation No. 10*, CFTC 7 (May 5, 2005), available at <http://www.cftc.gov/files/tm/tmint-10-1.pdf> ("Together with concerns regarding the risks to the general marketplace and market users, this is persuasive that third-party custodial accounts are no longer necessary or appropriate, except in the limited case where an FCM is precluded from holding RIC assets due to affiliation with a RIC or its adviser.").

187. *Public Roundtable*, *supra* note 184, at 246.

customer funds because these funds would be completely segregated from the FCM.¹⁸⁸ The complete segregation would prohibit an FCM from misusing or misappropriating customer funds like those discovered in the MF Global and Peregrine Financial bankruptcies.¹⁸⁹

Under this custodial arrangement, the FCMs would only have access to the custodial account when the client funds are needed to reimburse the FCM who posted a margin call to the clearing house on behalf of the customer.¹⁹⁰ Otherwise, these customer funds would primarily stay segregated from the FCM in a custodial bank, and the interaction between the customer funds, the custodial bank, and the FCM would be outlined in a third party custodial agreement.¹⁹¹ These agreements between the parties would be optional.¹⁹² To clarify, regulators would not force FCMs and customers to utilize the third party custodial account system.¹⁹³

1. Benefits of a Third Party Custodial Account System

A third party custodial account system would provide many benefits.¹⁹⁴ First, FCMs would have limited access to customer funds and the custodial bank would protect the customer's account.¹⁹⁵ The FCM would only have access to the customer's custodial accounts when the FCM needed the customer funds to meet a margin call or another arrangement designated in the third party custodial agreement.¹⁹⁶

A secondary benefit of a third party custody arrangement would be that the custodial bank could independently verify the amount of customer funds held in the custodial account.¹⁹⁷ The independent verification from a party other than the FCM gives the customer more confidence and assurance that his funds are not being misused by an FCM.¹⁹⁸

Furthermore, the custodial account benefits the system as whole because FCMs will post their own monies to clearing houses when a margin call is pending, and the clearing houses will be fully funded throughout the entire process. The FCM, of course, will then be able to reimburse itself by tapping into a customer's custodial accounts.¹⁹⁹ Despite these benefits, the third party custodial account alternative also comes with some associated costs and drawbacks.²⁰⁰

2. Drawbacks of a Third Party Custodial Account System

The first drawback of the third party custodial account is an important one: although the custodial account protects a customer from fraud by an FCM, the

188. *Id.* at 244.

189. *See id.* at 247.

190. *See id.*

191. *Id.* at 250–51.

192. *Id.*

193. *Id.*

194. *See id.* at 244, 247–49.

195. *See id.* at 247–48.

196. *See id.*

197. *Id.* at 248.

198. *See id.*

199. *See id.*

200. *See id.* at 247–49.

custodial accounts do not protect customer funds from being lost if the FCM were to go bankrupt or become insolvent.²⁰¹ Accounts held in these custodial accounts would be customer accounts under the bankruptcy code, which would result in any remaining available customer funds being distributed on a pro rata basis to all customers involved.²⁰² Thus, the risk of losing customer segregated funds from a defaulting FCM still looms large if the custodial account regime were adopted.²⁰³

A second drawback of a third party custodial account system is the costs that are involved in opening and maintaining these custodial accounts.²⁰⁴ Indeed, the costs of these custodial accounts would only allow the largest investors to benefit from this system because maintenance and carrying fees would be associated with these accounts.²⁰⁵ Along these same lines, the custodial account structure requires the FCMs to meet margin calls with their own separate funds directly, because margin calls cannot be posted to a clearing house directly from a custodial account.²⁰⁶ Thus, the FCMs will need to carry a sufficient amount of capital to meet the margin calls for customer accounts, and this could be burdensome to smaller futures traders.²⁰⁷

The last drawback of a third party custodial account could be an increase in transactional costs associated with creating a third party agreement.²⁰⁸ The contractual nature of these agreements depend on negotiated terms and conditions, and, due to multiple parties, the deliberations can be complex and contentious.²⁰⁹ Further, it would take more regulatory collaboration of different government entities to coordinate policies and procedures for the custodial accounts.²¹⁰ Regulators of both banks and FCMs would need to work together to provide oversight to these arrangements.²¹¹ Again, the costs of this system outweigh the benefits, which warrants further consideration of other alternatives.

C. Customer Guaranty Fund

John Roe, of the Commodity Customer Coalition, proposed an alternative to an industry sponsored insurance fund with an industry-funded liquidity facility, called the Customer Guaranty Fund.²¹² Although the Customer Guaranty Fund and the Industry Sponsored Insurance Fund are similar, Roe's plan accounts for the differences in the commodities market and the securities market.²¹³ Roe says it is unwise to base an insurance plan for the commodities market on the SIPC framework.²¹⁴ Instead, Roe's proposal creates a liquidity facility designed to avoid

201. *Id.* at 252–56.

202. *See id.*

203. *See id.*

204. E-Mail Interview with Johnson, *supra* note 172.

205. *Id.*

206. *See Public Roundtable*, *supra* note 184, at 246.

207. *See id.* at 246, 256–57; E-Mail Interview with Johnson, *supra* note 172.

208. E-Mail Interview with Johnson, *supra* note 172.

209. *Id.*

210. *Id.*

211. *See id.*

212. *See* Chilton & Roe, *supra* note 16; *Hearing on Futures Markets*, *supra* note 15, at 2–3 (testimony by John Roe, Co-Founder, Commodity Customer Coalition).

213. *Public Roundtable*, *supra* note 184, at 300.

214. *See id.*; *see* Chilton & Roe, *supra* note 16.

bankruptcy proceedings, with respect to customer accounts, in the event of FCM insolvency.²¹⁵

Under this proposal, Roe argues for the creation of a private, non-profit corporation that will hold a guaranty fund raised from an explicit and fixed transaction fee assessed per futures contract.²¹⁶ This nonprofit corporation would have the power to assess fees on its members and mandate registration with the entity.²¹⁷ After the initial fund is created, the fund would focus on “providing liquidity to plug shortfalls in customer property, and ensure that accounts are quickly transferred to new brokers.”²¹⁸ As such, once created, the non-profit corporation will pay back customer funds in the event of insolvency and facilitate customer account transfers to new brokers.

In this process, the Customer Guaranty Fund would then “[step] in the shoes of customers by taking their claims to bankruptcy.”²¹⁹ In the bankruptcy proceedings, the FCM must pay claims to the Guaranty Fund that, on behalf of the customers, absorbed the initial losses (if any) of misused customer funds by the insolvent FCMs.²²⁰ Thus, it is imperative that the Customer Guaranty Fund “be subrogated to customer claims so that it can recoup advances made to the customers of a failed FCM.”²²¹

1. Benefits of a Customer Guaranty Fund

The Customer Guaranty Fund proposed by John Roe has many of the same benefits associated with the creation of an insurance fund.²²² This Customer Guaranty Fund could return confidence to the futures market while establishing a mechanism that would protect customer segregated funds from the consequences of FCM bankruptcy.²²³ Specifically, the Customer Guaranty Fund would eliminate an aspect of moral hazard that would be associated with an Industry Sponsored Insurance Fund. The Customer Guaranty Fund, through its subrogated claims, would subject a defaulting FCM to the claims of customers through the bankruptcy process.²²⁴ Indeed, the subrogated Customer Guaranty Fund would pursue customers’ claims in bankruptcy and demand payment if one were available through the bankruptcy process.²²⁵ Thus, assuming customer accounts were not absconded by an insolvent FCM, the Customer Guaranty Fund would likely stand idle, and not be a participant in the bankruptcy proceedings.²²⁶ In the event that losses to customer funds were a result of FCM misuse, the fund would provide

215. See *Public Roundtable*, *supra* note 184, at 297–304.

216. See Chilton & Roe, *supra* note 16.

217. See *id.*

218. *Hearing on Futures Markets*, *supra* note 15, at 2 (testimony by John Roe, Co-Founder, Commodity Customer Coalition).

219. See *Public Roundtable*, *supra* note 184, at 299.

220. See *id.*

221. Chilton & Roe, *supra* note 16.

222. See *id.*; see Byrne, *supra* note 151.

223. See *Hearing on Futures Markets*, *supra* note 15, at 2–3 (testimony by John Roe, Co-Founder, Commodity Customer Coalition).

224. See *Public Roundtable*, *supra* note 184, at 298–99.

225. See *id.*

226. See *id.*

liquidity for the customers to transfer to a new broker. The Customer Guaranty Fund would then replenish itself by making claims on the FCM as a creditor.²²⁷

Another positive to the Guaranty Fund is that a congressional act would not be necessary to implement this program as opposed to a mandatory industry sponsored insurance plan.²²⁸ The Customer Guaranty Fund would function like a corporation, and would be owned and operated by the exchanges and the FCMs.²²⁹ The Customer Guaranty Fund Corporation would create guidelines for membership and would assess a transaction fee to customers so they would be covered by the fund in the case of an FCM default.²³⁰ Fees would cease once the Customer Guaranty Fund produced a one percent reserve ratio of the aggregate amount of customer segregated funds held in the commodity futures market.²³¹

Under Roe's proposal, the CFTC and market exchanges seem to be the likely candidates to set the one percent reserve ratio, and this ratio could be calculated on the previous year's total amount of funds held in customer segregated accounts. This data could be obtained from, for example, the Bank for International Settlements ("BIS"), an international financial organization. The level of details for the reserve ratio calculation was not, at the time of the writing of this Article, readily transparent.

2. Drawbacks of the Customer Guaranty Fund

Nevertheless, the Customer Guaranty Fund is one alternative that, in theory, works like an industry sponsored insurance fund.²³² Consequently, many of the same costs are associated with its creation, and these costs might deter some of the industry's largest traders from participating in the futures market.²³³ First, the monetary caps on a Customer Guaranty Fund will be similar to that of an insurance fund, which creates the risk of the fund underinsuring the large amount of funds held in customer accounts. Second, the same kind of moral hazard associated with an insurance fund can be found when creating this kind of liquidity fund where customers do not perform their due diligence in selecting FCMs. Finally, the costs associated with transaction based assessments on each trade to build the Customer Guaranty Fund could be sufficient to deter market participants from engaging in this kind of customer protection fund.

D. Central Customer Funds Repository

After the collapse of MF Global, former CFTC Chairman Philip McBride Johnson proposed the idea of a Central Customer Funds Repository ("CCFR"). A CCFR would be a regulated and licensed private corporation that would hold customer segregated funds independent from respective FCMs and it would directly interact with the clearing organizations to pay and collect funds for

227. *See id.*

228. Chilton & Roe, *supra* note 16.

229. *See id.*

230. *Id.*

231. *Id.*

232. *See Public Roundtable, supra* note 184, at 297–99.

233. *See* E-Mail Interview with Johnson, *supra* note 172.

futures transactions.²³⁴ After these transactions are settled, the independent entity would remit these funds directly to the customers.²³⁵ This new entity would house customer funds and eliminate a substantial amount of risk associated with FCMs holding customer segregated funds.²³⁶

Johnson suggests that the CCFR could adopt a structure where the FCMs would be the owners of the Repository while separate, independent management would be contracted out to an experienced risk management organization.²³⁷ The sole business of the CCFR, however, would be to receive, disburse, and manage customer funds of futures traders.²³⁸ Laws and regulations will need to change to ensure that the CCFR is an affiliate of the FCMs protecting the CCFR from liabilities attributable to the FCM.²³⁹

The CCFR would function as follows. Futures customers would still have a regular relationship with their FCMs.²⁴⁰ However, when a customer initially opens an account with the FCM, the customer would also open an account with the CCFR, which would directly control all funds transfers.²⁴¹ From the CCFR account, the CCFR would handle all the transactions associated with the various clearing houses.²⁴² For this system to work, the CCFR would need to collaborate with the FCMs to find out the real time data on activity occurring in each customer account that affects what it needs to receive and disburse to the appropriate clearing houses.²⁴³ As a result, the FCM would need to provide the CCFR with full access to its databases of customer accounts.²⁴⁴

1. Advantages of the CCFR

The advantage of the CCFR is that an FCM would not have direct access to customer funds when, if at all, it was facing an imminent insolvency. Customer funds would be totally separated from the FCM, and the CCFR would directly interact with the DCO when one of DCO clearing members is under financial distress. As such, customer accounts are better protected from misuse when a distinct and separate entity is interfacing with the DCO directly. The CCFR and not the FCM would post maintenance margin with the DCO. The FCM would not be the party that would channel the money to the DCO as it does in third party custodial accounts. This approach makes customer monies totally segregated from FCMs which eliminates the possibility of FCM misuse. Thus, the CCFR decreases the possibility of default and malfeasance risk associated with an FCM and customer segregated funds.

234. Johnson, *supra* note 17.

235. *Id.*

236. *Id.*

237. *Id.* at 1–2.

238. *Id.* at 2.

239. *Id.*

240. *Id.* “Customers would continue to forge a relationship with a broker. The terms of account would be set between the parties. As at present, the customers would work with a favored adviser within the broker, would submit trade orders and receive trade confirmations, would receive monthly statements and margin notices.” *Id.*

241. *Id.* at 1.

242. *Id.*

243. *Id.* at 2.

244. *Id.* at 1–2.

2. Concerns of a CCFR

The issues associated with the creation of the CCFR are (i) whether the CCFR is feasible under the current regulatory and statutory regime; (ii) whether the CCFR would make any profit in handling the futures customers' funds; and (iii) whether the FCMs would be willing to agree to this kind of arrangement.²⁴⁵ As for the first issue, Johnson's proposes a slight alteration in the regulatory structure.²⁴⁶ Under current law, FCMs presumably handle segregated customer funds, unless there is written acknowledgment explaining that the third party bank, trust company, or clearing organization is holding customer funds on behalf of the FCM as a holding account for these specific funds.²⁴⁷ This presumption would need to be changed to allow the customer funds to be handled and invested by the CCFR, rather than leaving control of the funds with the FCM.²⁴⁸ Nevertheless, the change in law would be welcomed by the industry because the CCFR does not impose an additional cost on traders in creating a protective insurance or guaranty fund.

In regards to the second and third issue, Johnson's proposal notes that the CFTC estimates that there is nearly \$200 billion in customer segregated accounts in the futures commodity markets, and these funds could readily be invested by the CCFR in authorized securities.²⁴⁹ Thus, it is more than likely that the CCFR would turn a gross profit from the return associated with the investment of customer funds.²⁵⁰ FCMs will lose access to a significant portion of income from investing customer segregated funds.²⁵¹ Johnson argues this concern can be ameliorated by suggesting that the CCFR divide its investment income equally with FCMs in exchange for the FCM opening their entire database to the CCFR.²⁵² The exchange will be fair because the CCFR will need to utilize broker operating systems to manage its daily business, which lightens the work load for the FCM, and the FCM will get a share of the income generated from the investment of customer segregated funds.²⁵³ Also, FCMs will be enticed into this kind of an agreement with the CCFR because they would reduce their administrative and operating costs associated with handling customer funds.²⁵⁴

V. Recommendation for the Futures Commodity Market and Customer Segregated Funds

A. Introduction

Customers of the futures commodity market want more protection for their customer funds.²⁵⁵ The CFTC and the SROs have taken steps to provide more

245. See E-Mail Interview with Johnson, *supra* note 172.

246. *Id.* at 3.

247. See 17 C.F.R. § 1.20.

248. *Id.* at 3.

249. See Johnson, *supra* note 18 at 2; see 17 C.F.R. § 1.25.

250. See *id.*

251. *Id.*

252. *Id.*

253. Johnson, *supra* note 18, at 1-2.

254. *Id.* at 2.

255. See Byrne, *supra* note 151.

regulatory protection to these funds, but more can be done to quickly inject confidence into a market that has taken serious blows recently.²⁵⁶ Customer confidence is necessary; the market needs a mechanism that will alleviate customer concerns about a defaulting FCM misusing its customer funds.²⁵⁷ Thus, the question turns on what protective mechanisms outlined above could be implemented so the aggregate of market participants, large and small, would be satisfied with the changes adopted and would be comfortable with the imposed cost of a possible solution.

The tolerance of additional costs for market participants is a key issue in deciding the optimal solution for the protection of customer segregated funds in the event of an FCM default. First, all traders want to ensure that their customer funds will not be mishandled or lost by FCMs who are participating in risky business practices.²⁵⁸ This concern impacts small to medium size traders who are using the futures market to hedge market risk in physically settled commodity futures contracts. The small traders will be more affected than large traders because the additional resources needed to implement a protection mechanism for customer segregated accounts will likely impact the pricing of derivatives. Yet, these traders are willing to incur the additional cost associated with an industry sponsored insurance fund or a guaranty fund because they might not be willing to take on the additional risk that their funds could be absconded. Thus, they would prefer a market alternative that guarantees their funds would not be lost in light of an insolvent FCM.²⁵⁹ Although larger traders would also be concerned of recovery monies lost to an insolvent FCM, they could reduce their exposure by entering alternative positions in the market or by absorbing the trading losses with trading profits. The larger traders also have the resources to conduct a large amount of research and development when selecting an FCM, which limits their exposure to insolvent FCM.

On the other hand, the larger traders in the commodity market are less likely to tolerate the additional cost placed on them from the creation of an industry sponsored insurance fund or a third party custodial account.²⁶⁰ The additional cost placed on the larger traders creates an incentive for them to seek lower cost alternatives that would sufficiently meet their commercial needs, i.e., the private swap market or forward contracts.²⁶¹ Thus, Congress and the federal regulators must consider these two countervailing interests when contemplating a new protection for customer segregated funds.

B. Short Term Proposal and Long Term Consideration for the Protection of Customer Funds in the Commodities Futures Market

256. See *Hearing on Futures Markets*, *supra* note 15, at 4 (testimony by John Roe, Co-Founder, Commodity Customer Coalition).

257. See *id.* at 2, 4 (testimony by Dan Roth, President & CEO of Nat'l Futures Ass'n, testimony by John Roe, Co-Founder, Commodity Customer Coalition).

258. See Johnson, *supra* note 151; see Michael McFarlin, *How Safe Are Your Funds?*, FUTURES MAGAZINE (Aug. 30, 2012), <http://www.futuresmag.com/2012/08/30/how-safe-are-your-funds>.

259. See *Hearing on Futures Markets*, *supra* note 15, at 4 (testimony by John Roe, Co-Founder, Commodity Customer Coalition); see *id.* at 1–3, 5 (testimony by Diana Klemme, Vice President, Dir. Grain Div., Nat'l Grain & Feed Ass'n).

260. See E-Mail Interview with Johnson, *supra* note 172.

261. See *id.*

This Article recommends that for new protections for customer segregated funds is derived from the alternatives discussed above by industry leaders, and the existence of the divergent interests between market participants in the commodity futures market. The proposal is meant to reduce the concerns of all market participants while speaking to futures traders of all sizes and wealth. This recommendation addresses a short-term proposal and a long term consideration.

Indeed, in the short term, an Optional Customer Guaranty Fund, similar to the one discussed above, must be created.²⁶² However, the Optional Customer Guaranty Fund would differ from Roe's plan by making the participation in the Customer Guaranty Fund an optional right granted to the customers of the commodity futures market. Each customer would have the opportunity to choose whether he would like to be protected by an industry guaranty fund in the event of a default by an FCM. Of course, this optional feature allows the market participants to decide the amount of protection they want for the customer segregated funds and the amount of cost they want to incur with each futures trade.²⁶³ A transactional fee and a membership fee would be implemented on the trades of customers who decide to participate in the Optional Customer Guaranty Fund. If a futures customer does not want to participate in the Optional Customer Guaranty Fund, he will not have a transactional and membership fee assessed on his trades.

If a customer account opts in to the protection provided by the Customer Guaranty Fund, then he would be assessed a transaction fee for each futures contract that he entered.²⁶⁴ Also, the FCMs would be charged a membership fee to be a member of the Customer Guaranty Fund Corporation.²⁶⁵ These fees would accumulate into a pool and would cease when a one percent reserve ratio was reached. The ratio would be created by the CFTC, and it would be based on the previous year's total amount of customer segregated funds held by FCMs. If, however, a holder of a customer segregated account opts out of the protection or fails to communicate with the Customer Guaranty Fund Corporation, he will not be assessed any transactional fee, and will only be subject to the fees charged by his FCM for performing the transaction. These customers who opt out will not be protected by the Customer Guaranty Fund in the event their FCM collapses and there is a shortfall in customer segregated funds.

In the event of an FCM default, the optional Customer Guaranty Fund will provide liquidity to customers who have opted in and have decided that the benefits of trading are more than the applicable transaction and membership fee. The Optional Customer Guaranty Fund will allow these customers to be transferred to a stable FCM if their respective FCM has become insolvent.²⁶⁶ The Guaranty Fund Corporation will record and account for the customers who have opted into the program so they know how much insured customer funds were held in certain FCMs, and who those customers are specifically. This Customer Guaranty Fund will also step into the shoes of those qualifying customers in the

262. See Chilton & Roe, *supra* note 16.

263. See *Public Roundtable*, *supra* note 184, at 251.

264. See Chilton & Roe, *supra* note 16.

265. See *id.*

266. See *id.*

bankruptcy proceeding.²⁶⁷ Optional guaranty protection for customer segregated funds is a solution that covers the interests of large and small traders. The larger traders will be able to avoid the associated costs of an optional industry sponsored guaranty fund by opting out of the protection provided. Thus, large traders will not have to consider fleeing the commodity futures market in order to meet their financial needs at the most cost effective method.²⁶⁸ The smaller traders, alternatively, will be able to opt in to the guaranty fund program, and their confidence in the markets will increase.²⁶⁹ Each smaller trader of customer segregated funds will be protected from FCM default by incurring additional costs on their transactions.²⁷⁰

The optional aspect of this Article's solution is what makes this solution more feasible than the Industry Sponsored Insurance Fund and the Guaranty Fund promoted by Roe. The additional costs of having a protective fund can be avoided by the larger traders while the smaller traders, in exchange for a fee, can have protection against an FCM's insolvency. This makes for an optimal solution where customer funds would be protected if FCMs mishandle their customer segregated funds. Further, the Optional Guaranty fund is superior to a third party custodial account because the Optional Guaranty Fund will allow those who opt in to avoid bankruptcy proceedings while avoiding the cost associated with creating a custodial account. Thus, in light of the MF Global and Peregrine Financial debacles, each individual investor will be able to decide whether he is willing to accept extra cost for additional protection from insolvent FCMs.

As for the long term consideration for the protection of customer segregated funds, the industry should implement one of the full segregation models explained above.²⁷¹ The CCFR should be adopted because it is the only model that provides full segregation of customer funds and would be accessible for all traders in the futures market.²⁷² The industry needs to implement the CCFR because such a repository would eliminate most of the risks associated with FCM default and the misuse of customer segregated funds.²⁷³ The most significant change the CCFR would bring is that margin would be posted by the CCFR while the customer segregated funds would be fully segregated from the FCMs.²⁷⁴ Indeed, the CCFR would post margin on behalf of the customer to the DCO, and the customer funds would be totally protected from FCM malfeasance.²⁷⁵ Every other alternative deliberated will not sufficiently remedy the risk of an FCM mishandling customer funds when it becomes insolvent because in each solution above, the FCM still has access to the funds when it is demanded to post margin with a DCO. Thus, the FCMs could still misuse these funds when it is in their possession and they are facing insolvency.²⁷⁶

267. See *Hearing on Futures Markets*, *supra* note 15, at 2 (testimony by John Roe, Co-Founder, Commodity Customer Coalition); see *Public Roundtable*, *supra* note 184, at 299.

268. See E-Mail Interview with Johnson, *supra* note 172.

269. See Byrne, *supra* note 151.

270. See Chilton & Roe, *supra* note 16.

271. See *Public Roundtable*, *supra* note 184, at 244–48.

272. See *id.*; see Johnson, *supra* note 18.

273. See Johnson, *supra* note 18, at 1.

274. See *id.* at 1–2.

275. *Id.*

276. See E-Mail Interview with Johnson, *supra* note 172.

Specifically, a Tri-Party Custodial system might only be feasible for the largest traders of the commodity futures market because of the high expense involved and the complex contractual rights associated with the maintenance of these accounts.²⁷⁷ A CCFR plan can also come with complex contractual rights. However, a CCFR and an FCM relationship can be outlined by a congressional made standardized, non-negotiable contract, which would come with less cost than a third party custodial contract. The CCFR is the appropriate full segregation mechanism that needs to be implemented as a reasonable long term solution to fully protecting customer funds in the commodity futures market, and is the only viable solution that promotes a full segregation model.

Further, an industry sponsored insurance fund and a customer guaranty fund do little to pacify the concern of FCMs misusing customer segregated funds.²⁷⁸ Rather, these alternatives merely provide a protection mechanism if an FCM is found to mishandle customer funds.²⁷⁹ The CCFR, on the other hand, provides a full segregation model that eliminates an FCM's ability to misuse customer funds.²⁸⁰ This is why the aforementioned Optional Guaranty Fund should be eliminated once Congress implements the CCFR. A phase out plan of an optional guaranty, described below, should be used when the CCFR is established. The CCFR eliminates an FCM's ability to misuse customer funds while also providing protection from an FCM that has become insolvent.²⁸¹ Thus, the CCFR is the superior model in light of protecting customer segregated funds.

C. Proposal: Phasing of Short and Long Term Solutions

Once the CCFR is functional, the Optional Guaranty Fund would remain in existence for three years. In these three years, regulators and Congress could tweak the problems associated with the CCFR. After year three, the Optional Guaranty fund model will begin a phase out process, and customer funds would, by law, be transferred to the CCFR by the FCMs. Of course, those customers not participating in the Optional Guaranty Fund would be mandated to have their FCMs transfer their funds to the CCFR. After this transfer, the Optional Guaranty Fund Corporation would be dissolved, and all customer funds would be held by the newly created CCFR.

VI. Conclusion

After the bankruptcies of MF Global and Peregrine Financial Group, the customers of the commodity futures market were shaken, and their trust in the market evaporated. Industry regulators have responded with great systematic changes to the regulatory regime, but customers seem to want more protection for their customer funds. In spring 2013, the Futures Industry Association ("FIA"), CME Group, the NFA, and the Institute for Financial Markets ("IFM") examined the possibility and available alternatives of an investor protection fund for the

277. *See id.*

278. *See* Chilton & Roe, *supra* note 16.

279. *See id.*

280. *See* E-Mail Interview with Johnson, *supra* note 172.

281. *See id.*

futures markets. At the time of this writing, the industry is awaiting a definite proposal by these organizations for the feasibility of an investor protection fund. Futures market regulators have collaborated to create safeguards for customer funds; however, market participants await a concrete proposal from these trade and self-regulatory organizations for additional protection for customers.²⁸² Industry leaders have proposed and deliberated a wide range of ideas for protection as described in this Article, yet there has been no indication whether an investment protection fund of any sort will be pursued.²⁸³

Though the industry will consider the alternatives considered in this Article, any new regime undertaken will need to weigh the cost and benefits related to all market participants. Larger traders in the commodities futures market do not want to be burdened by unreasonable additional cost while the smaller traders want their customer funds to be fully protected in the event of an FCM collapse. For immediate protection of customer funds, the futures market should implement an Optional Guaranty Fund to remedy concerns of misuse of customer funds. As a long term solution, a Central Customer Fund Repository should be created for the protection of customer funds. This mechanism would provide the highest level of protection for customer segregated funds, and this would inject confidence into the commodities futures market.

282. *See generally Public Roundtable, supra* note 184.

283. *See id.*