U.S. COMMODITY FUTURES TRADING COMMISSION
ENSURING THE INTEGRITY OF THE FUTURES & OPTIONS MARKETS

SPEECHES & TESTIMONY

Dissenting Statement of Commissioner Scott D. O'Malia, Enhancing Protections Afforded Customers and Customer Funds Held by Futures Commission Merchants and Derivatives Clearing Organizations[1]

October 30, 2013

I respectfully dissent from the Commission's approval today of the final Customer Protection Rules.

I supported the proposed rules because I wanted to solicit public comment and engage market participants in an open discussion about how the Commission should improve its customer protection regulatory oversight.

In the wake of the global financial crisis, it is extremely important to intensify regulatory efforts to strengthen customer protection policies in order to promote the financial stability of the derivatives markets. There is no dispute customer protection must be the cornerstone of the Commission's oversight. Sound customer protection policies and measures, such as the electronic customer verification confirmation services will improve the efficiency and transparency of financial markets.[2]

The Commission must promulgate workable regulations that provide clear guidance to industry participants and ensure cost-effective access to markets. Such regulations must be designed to address real weaknesses in the current regulatory regime and allow industry participants to continue with well-established industry practices that had nothing to do with the financial crisis or the recent bankruptcies of MF Global and Peregrine Financial.

Unfortunately, the Commission's customer protection rules fall short of these objectives. Instead of mitigating customer risk, the rules create a false sense of security by imposing broad and ambiguous requirements and introducing another layer of governmental oversight. Even worse, they force a change in a longstanding and generally accepted industry practice that will likely result in seriously harmful consequences for small FCMs and their end-user customers.

I do support several provisions that allow customers greater insight into the operations of an FCM. These provisions include: an improved FCM disclosure regime that will give customers new and critical information about their FCM exposures, elimination of the alternative method of calculating segregation requirements for §30.7 funds (treatment of foreign futures or foreign options), improved reporting of segregated fund balances, and enhancements to risk management procedures. However, I am unable to support the final rule for the reasons stated below.

Reinterpretation of the residual interest deadline will result in costly prefunding of margin payments.

My main concern with the final rules is their radical reinterpretation of the longstanding residual interest deadline. This reinterpretation decreases the time in which customers' margin calls must arrive to their FCM from the current three days to just one day.

Such a change would mean a drastic increase in pre-funding of margin, perhaps nearly double the amounts currently required. As a result, many small agribusiness hedgers will have to consider alternative risk management tools or, even worse, will be forced out of the market.[3] I am disappointed that yet again the Commission has rushed to implement a rule that disregards the express Congressional directive to protect end-users.

I recognize that the Commodity Exchange Act (CEA) does not permit an FCM to use the money or property of one customer to margin the futures or option positions of another customer.[4] Despite this fact, it has been the prevailing industry practice authorized by the Commission for decades.

To the extent that the Commission must reinterpret this statutory provision, I believe this reinterpretation must be based on the thorough analysis of the market data and the full evaluation of the costs of strict compliance with the statute before implementing policy changes, and not after as is the case with the residual interest deadline.

The residual interest deadline rule makes no effort to respond to the commenters' concerns that the residual interest deadline would be especially costly for smaller FCMs and end-users.[5] Given the express Congressional directive to protect end-users, I would have expected the Commission to conduct meaningful cost-benefit analysis to justify the costs when compared to the actual risk to customer accounts and the derivatives markets and to explain why the Commission could not have adopted an alternative approach. Regrettably, the Commission has failed to do so.

Even the Commission's own cost benefit analysis points out, while significantly understating the impact, that:

"Smaller FCMs may have more difficulty than large FCMs in absorbing the additional cost created by the requirements of the rules (particularly §1.22). It is possible that some smaller FCMs may elect to stop operating as FCMs as a result of these costs."[6]

I cannot support a rule that will impose such onerous costs and compliance burdens on the smallest FCMs and small, non-systemically relevant customers.

Finally, although I support a phase-in compliance schedule for the residual interest deadline, I am disappointed that the Commission, in deciding whether to change the deadline at a future time, is not required to make such a decision based on data. Instead, the Commission will simply come up with another arbitrary residual interest deadline that has nothing to do with customer or FCM risk exposure.

Yet again, the Commission has chosen to avoid fact-based analysis. I strongly believe that the Commission should utilize facts and data to make an informed decision about the appropriate time for the residual interest deadline.

The rules fail to provide a clear standard for compliance.

In addition to my serious concerns about the final rules' treatment of the residual interest deadline, I am concerned that the rules unreasonably expand the scope of the new regulatory compliance regime without providing a clear regulatory objective.

For example, the rules require that a Self-Regulatory Organization (SRO) supervisory program "address **all areas of risk** to which [FCMs] can reasonably be foreseen to be subject (emphasis added)."[7] This broad language requires the SRO to guess at what criteria the programs would be measured against, and under what framework the SRO would make this determination. In short, the new language does nothing but adds more ambiguity to the SRO's customer protection program and increases the cost of compliance with vague requirements.

Examination experts do not add value to the customer protection regime.

I also have concerns about the requirement that each SRO supervisory program of its member FCMs be reviewed by an "examinations expert."[8] I question the benefit of this requirement given the fact that the Joint Audit Committee (JAC) currently performs this function. The JAC's primary responsibility is to oversee the practices and procedures that each SRO must follow when it conducts audits and financial reviews of FCMs. This regulatory task is already in place and implemented in a less costly and more efficient manner than set forth in the final rules.

Moreover, in light of the Commission's regulatory oversight of all SROs and the Commission's review of all JAC examination programs, this additional layer of review does not provide any benefit except for isolating the Commission from its primary responsibility to oversee customer protection programs.

Customers deserve better protections in bankruptcy proceedings

Going forward, the Commission should address key customer protections in the areas of bankruptcy. Congress should make changes to the Bankruptcy Code to ensure that certain bankruptcy protections are afforded to FCM customers. Specifically, Congress should amend the pro-rata distribution rules in bankruptcy. Despite the Commission's customer segregation requirements, individual customer accounts are still subject to a pro-rata distribution in bankruptcy. In addition to these changes to the Bankruptcy Code, the Commission should amend its rules to allow the Commission to appoint a trustee to oversee derivatives customers' accounts in the bankruptcy of a broker-dealer FCM.

Conclusion

I support implementation of a rigorous customer protection program that provides clear

and meaningful mechanisms for mitigating customer risks. However, the customer protection rules approved today have missed the mark.

In sum, many of the new rules impose overly broad and nonsensical regulatory requirements and, in doing so, impede the industry's ability to operate in an efficient manner. Regrettably, the negative effects will be felt most by farmers and other end-users, whose ability to hedge risk in a cost-effective manner will be hampered if not eliminated altogether. This is contrary to the Congressional directive, and I cannot support rules that result in such an outcome.

[1] "Customer Protection Rules"

[2] In this regard, I applaud the efforts of the Chicago Mercantile Exchange Inc. (CME) and the National Futures Association (NFA) to protect customer accounts by introducing daily electronic confirmation services. This new technology allows CME and NFA to review balances held at bank depositories and compare the balances with customer account information provide by futures commission merchants (FCMs).

[3] *See e.g.*; National Grain and Feed Association Comment Letter at 2 (Dec. 28, 2012) (stating that the Commission's proposed changes "could have the unintended impact of disadvantaging smaller and mid-size FCMs that provide 'hands-on' service to many of the relatively smaller hedgers in agribusiness"); Texas Cattle Feeders Association Comment Letter (Jan. 14, 2013) (warning that such changes "could have the potential to cause unintended consequences such as added costs eventually borne by customers"); Iowa Cattlemen's Association Comment Letter (Feb. 15, 2013) ("it is imperative that the CFTC understand all sizes of businesses . . . [in order to have] . . . a better opportunity to write rules that provide a logical fit. Our fear is that if this rule is put in place, we will have members who will not take advantage of the risk management tools . . ..").

[4] CEA § 4d(a)(2).

[5] Futures Industry Association Comment Letter at 16 (Feb. 15, 2013).

[6] Customer Protection Rules at 313.

[7] § 1.52 (c)(2).

[8] § 1.52.

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