MANAGED FUNDS ASSOCIATION

WRITTEN STATEMENT

OF

MANAGED FUNDS ASSOCIATION

For the Hearing
The Future of the CFTC: Perspectives on Customer Protections

BEFORE THE

SUBCOMMITTEE ON GENERAL FARM COMMODITIES
AND RISK MANAGEMENT
COMMITTEE ON AGRICULTURE
U.S. HOUSE OF REPRESENTATIVES

OCTOBER 1, 2013

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Managed Funds Association ("**MFA**") is pleased to provide this statement in connection with the House Agriculture Subcommittee on General Farm Commodities and Risk Management's hearing held on October 2, 2013 on "The Future of the CFTC: Perspectives on Customer Protections". MFA represents the majority of the world's largest hedge funds and is the primary advocate for sound business practices and industry growth for professionals in hedge funds, funds of funds and managed futures funds, as well as industry service providers. MFA's members manage a substantial portion of the approximately $2.375 trillion invested in absolute return strategies around the world. Our members serve pensions, university endowments, and other institutions.

MFA's members are among the most sophisticated institutional investors and play an important role in our financial system. They are commodity pool operators ("**CPOs**") and commodity trading advisors ("**CTAs**"), which are customers of futures commission merchants ("**FCMs**"). Our members are active participants in the commodity and securities markets, including over-the-counter ("**OTC**") derivatives markets. They provide liquidity and price discovery to capital markets, capital to companies seeking to grow or improve their businesses, and important investment options to investors seeking to increase portfolio returns with less risk, such as pension funds trying to meet their future obligations to plan beneficiaries. MFA members engage in a variety of investment strategies across many different asset classes. The growth and diversification of investment funds have strengthened U.S. capital markets and provided investors with the means to diversify their investments, thereby reducing overall portfolio investment risk. As investors, MFA members help dampen market volatility by providing liquidity and pricing efficiency across many markets. Each of these functions is critical to the orderly operation of our capital markets and our financial system as a whole.

MFA appreciates the Subcommittee's thoughtful review of and focus on customer protection issues. We supported financial reform and policymakers' goals to improve the functioning of the markets and to protect customers by endorsing central clearing of derivatives, increasing transparency and implementing other measures intended to mitigate systemic risk. We also appreciate that Congress remains vigilant about and has held hearings related to the MF Global, Inc. ("**MF Global**") and Peregrine Financial Group, Inc. ("**Peregrine**") insolvencies. Our members have investors in their funds; and are customers themselves, and therefore, we remain deeply troubled by the MF Global and Peregrine events and the consequences of their insolvencies.

Accordingly, we support thoughtful legislative and regulatory changes to strengthen protections of customers. We believe some additional refinements to the Commodity Exchange Act ("**CEA**") and the regulations of the Commodity Futures Trading Commission ("**CFTC**") would further fulfill the Subcommittee's objective to enhance protections for customers.

In these respects, we believe Congress should: (1) encourage the CFTC to finalize its proposed rules on enhancing customer protections with certain modifications intended to bolster the rules' efficacy; (2) amend the Bankruptcy Code to help shield the collateral of cleared swaps customers from another MF Global or Peregrine-like failure; (3) encourage the CFTC to repeal the prohibition on futures customers' use of third-party

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custodial accounts as a mechanism to protect their collateral; and (4) amend the CEA by adopting stronger protections for confidential information.

MFA appreciates the Subcommittee's consideration of this written statement. As customers and active participants in the derivatives markets, we are committed to working with the Congress, the CFTC and other interested parties in addressing customer protection issues.

CFTC RULES ON ENHANCING CUSTOMER PROTECTIONS

MFA strongly supports the CFTC's issuance of proposed rules on enhancing customer protections (the "**Proposed Rules**")[1], and the CFTC's efforts to ensure adequate protection of customers and their funds by augmenting the requirements imposed on FCMs and enhancing the oversight of FCMs. As customers in the derivatives markets, we applaud the CFTC for recognizing the potential weaknesses in the current customer protection regime and proposing thoughtful measures to increase the protection and confidence of customers. We ask the Subcommittee to support the CFTC in finalizing the Proposed Rules with certain modifications that we, as customers, believe would assist Congress and the CFTC in furthering its customer protection goals.

Residual Interest Requirement

MFA agrees with the CFTC that the timely collection of margin is a critical component of an FCM's risk management program, and that it is important to require FCMs to hold sufficient funds to protect against insufficient margin in customer accounts. However, from a practical perspective, we are concerned about the CFTC's proposed residual interest requirement, which would require an FCM to maintain its own funds "at all times" in an amount sufficient to exceed the sum of all of its futures customers' margin deficits.

MFA emphasizes that it supports the retention of the residual interest requirement. However, as proposed, the continuous "at all times" nature of the residual interest requirement would not provide FCMs sufficient time to collect margin from their customers. The unintended result for customers is that it could significantly increase our operational burdens and costs because, to ensure compliance with the residual interest obligation, FCMs might require their customers to pre-fund their margin obligations or to meet intraday margin calls.

MFA views both of these outcomes as troubling and an unacceptable imposition on customers. In particular, it would create margin inefficiencies by causing customers to reserve assets to pre-fund their obligations or in anticipation of intraday margin calls,

[1] 77 Fed. Reg. 67866 (November 14, 2012).

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and thus, reduce the amount of assets that customers have to use for investment or other purposes.

As a compromise, to preserve the residual interest requirement (which we agree is important) while avoiding the negative impact and burdens on customers, MFA recommends that the Subcommittee encourage the CFTC to finalize the Proposed Rules but modify the proposed residual interest requirement so that it is not a continuous real-time obligation, but rather a "point in time" obligation. We believe the appropriate "point in time" is close of business Eastern Time on the business day after the FCM issues a customer's margin call, which is consistent with current margin practices and infrastructure. This approach would eliminate the need for customer pre-funding or intraday margin calls, while also ensuring that FCMs hold sufficient funds to protect one customer from another customer's shortfall or margin deficit.

Disclosure of FCM Information to Customers

MFA strongly supports the CFTC's proposals that would require FCMs to provide enhanced reporting and disclosure of certain information to customers and the public. Increasing the transparency of customers and the public into the operations, accounts, policies and procedures of FCMs is crucial because it would place customers in a better position to assess an FCM's stability, and if customers identify concerns and deem it appropriate, to transfer their positions and funds to a different FCM. Customers also would be in a better position to assist the CFTC and designated self-regulatory organizations ("**DSROs**"), that supervise FCMs for example, by alerting the CFTC or DSRO to customer concerns with the FCM or the FCM's decisions. Therefore, MFA believes that, in the aggregate, the enhanced disclosure in the Proposed Rules will give customers comprehensive information about FCMs' risks, and allow them to make meaningful judgments regarding the appropriateness of using a particular FCM.

In light of the importance of FCM disclosures to customers and the public, MFA believes that additional public disclosure of certain FCM information (*i.e.*, in addition to what the CFTC has proposed in the Proposed Rules) will be beneficial to the market. In particular, as the CFTC is finalizing the Proposed Rules, we ask the Subcommittee to encourage the CFTC to mandate that FCMs make publicly available each month their computations for, and compliance with rules related to, segregated customer collateral as well as FCMs' summary balance sheets and income statement information for the most recent twelve months.

MFA believes that imposing such a public disclosure obligation on a monthly basis is important because an FCM's financial stability may change significantly in a short amount of time. Therefore, we believe less frequent disclosure to the public is insufficient from a customer protection perspective.

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Protection of Cleared Swaps Customer Collateral

MFA supports efforts to strengthen the legal framework applicable to collateral for customers related to cleared swaps transactions with FCMs. As mentioned, MFA remains concerned about the MF Global and Peregrine Financial insolvencies. The misuse or misplacement of customer funds in those situations resulted in customers experiencing a delay, in some cases a significant delay, in the return or outright loss of substantial amounts of their assets. Therefore, we believe that Congress should amend the Bankruptcy Code to bolster the protection of customer collateral.

Under current law, if an FCM becomes insolvent, all of the collateral of the FCM's cleared swaps customers would be aggregated and distributed to each customer on a *pro rata* basis. Therefore, even when a customer was not at fault, if there is an insufficient amount of cleared swaps customer collateral available in the FCM's customer account to repay all customers who posted collateral, the customer would lose a portion of its posted collateral. To remedy this concern, we urge Congress to amend Chapter 7 of the Bankruptcy Code so that, upon an FCM's insolvency, customer assets posted as collateral on cleared swaps transactions would not be subject to *pro rata* distribution. Such an amendment would ensure that cleared swaps customers do not share in any shortfall due to the FCM's or another customer's default.

An amendment to the Bankruptcy Code also would enhance the effectiveness of existing and potential segregation protections for cleared swaps customers. For example, the CFTC has adopted the "legally segregated operationally commingled" model ("**LSOC**") for cleared swaps, which should generally reduce the likelihood of there being a customer asset shortfall in certain FCM default scenarios. However, uncertainty remains as to how LSOC will perform in an FCM insolvency. An amendment to the Bankruptcy Code, as discussed above, would alleviate this uncertainty and further assure the protection of non-defaulting customers in certain FCM default situations.

In addition, market participants are continuing to consider other enhancements to customer protections, such as optional full physical segregation of customer collateral. This arrangement would allow a customer to put its collateral in an account with a custodian or other third party in the customer's name, rather than have the customer's FCM hold its collateral directly, and thus, protects the customer in the event that its FCM or another customer becomes insolvent. Without a Bankruptcy Code amendment, however, a cleared swaps customer's physically segregated collateral might be considered part of the pool of customer assets of the insolvent FCM, and thus, distributed on a *pro rata* basis. Therefore, MFA believes that, if Congress amended the Bankruptcy Code, it would significantly enhance customer protection.

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Protection of Futures Customer Collateral

In light of the MF Global and Peregrine failures, MFA feels it is also appropriate for the CFTC to re-examine the protections available to participants in the futures market, and to assess the appropriate balance between the costs of enhanced protections versus the costs to investors and the market as a whole of a segregation failure. As mentioned, we appreciate that the CFTC is working on proposals to enhance customer protections. As a further step, we think that the Subcommittee should encourage the CFTC to hold one or more roundtables, as the CFTC did when considering segregation rules for cleared swaps, to ensure full consideration of the lessons learned, and to assess whether further protections of the collateral of futures customers are appropriate.

In addition, MFA believes that the Subcommittee should encourage the CFTC to repeal CFTC Staff Segregation Interpretation 10-1 ("**Interp. 10-1**"), which prohibits futures customers from holding their collateral in accounts at a third-party custodian, rather than with their FCM counterparty. Although the CEA already requires an FCM to maintain all customer collateral separate from the FCM's own funds, it is also important that futures customers have the right to maintain their collateral remotely from their FCM counterparties at a third-party custodian. Allowing futures customers to use third-party custodial is an important step towards safeguarding customers' assets because those accounts would: (1) protect one futures customer from another futures customer's default; (2) protect futures customers from FCM operational and investment risk; and (2) facilitate the prompt transfer of futures customers' positions and collateral upon their FCM counterparty's default.

Some of our members already have third-party custodial accounts in place in the OTC derivatives market for collateral they have posted on uncleared swap positions. Moreover, when the CFTC adopted LSOC for cleared swaps, the CFTC clarified that the prohibition on the use of third-party custodial accounts contained in Interp. 10–1 does not apply to collateral posted by cleared swaps customers. MFA believes that there is no difference between cleared swaps and uncleared swaps on the one hand and futures on the other that supports retaining Interp. 10-1 for futures and limiting futures customers use of third-party custodial accounts. Rather, it is important that all customers have equal protection of their collateral regardless of what products they trade.

Therefore, MFA requests that the Subcommittee encourage the CFTC to repeal Interp. 10-1 for futures and allow futures customers to use third-party custodial accounts to ensure that the collateral that futures customers post is protected in a manner that is robust and equal to the protections available to swaps customers.

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STRENGTHENING PROTECTIONS FOR CONFIDENTIAL/PROPRIETARY INFORMATION

Reports of Commodity Pool Operators and Commodity Trading Advisors

MFA believes that Congress should strengthen the confidentiality protections for proprietary data in the CFTC's possession. MFA consistently has supported reasonable reporting requirements to ensure that regulators have meaningful data upon which to make sound policy decisions, but it is critically important that our members know that in fulfilling their reporting obligations, their proprietary portfolio and other confidential information is appropriately safeguarded. Market participants—whether hedgers or investors—invest significant research, time and resources into developing proprietary hedging or investment strategies. Such trading strategies are proprietary information; the CEA and other statutes have recognized the legitimate commercial need to protect the confidentiality of such information.

At the same time that the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 ("**Dodd-Frank Act**") required members of the Financial Stability Oversight Council ("**FSOC**"), including the CFTC, to collect sensitive and confidential data for the purpose of assessing financial stability, it also included important provisions directing FSOC members to maintain the confidentiality of such data. The Dodd-Frank Act specifically amended the Investment Advisers Act of 1940 to protect the confidentiality of reports that the SEC requires for SEC-registered investment advisers, but no corresponding amendments were made to the CEA for CFTC reports. Such amendments would be appropriate to ensure that consistent confidentiality protections would extend to the reports, documents, records and sensitive and proprietary information of CPOs and CTAs.

The current inconsistency between the confidentiality protections afforded to reports by investment advisers as opposed to reports by CPOs and CTAs creates two potential difficulties. First, it may expose data from CFTC-regulated entities to greater risk of public disclosure. Second, it creates a potential unlevel regulatory playing field, disadvantaging the CFTC in its efforts to collect, analyze, and share data. For example, we note that the SEC and CFTC have jointly adopted Form PF for certain reporting obligations. A dually registered entity filing Form PF with the SEC would have greater confidentiality protection than if the entity filed the exact same report with the CFTC. To afford confidential information consistent treatment for CPOs and CTAs as well as investment advisers, we recommend that the Subcommittee consider amending section 8 of the CEA by extending these important Dodd-Frank Act protections for sensitive or proprietary information to CPOs and CTAs.

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Protection of the Identity of Traders and the Confidentiality of Trade Data

MFA believes that Congress should amend the CEA to strengthen the confidentiality requirements for registered swap data repositories ("**SDRs**") and other regulated market utilities, such as self-regulatory organizations, swap execution facilities ("**SEFs**"), designated contract markets ("**DCMs**"), and derivatives clearing organizations or clearinghouses ("**CCPs**") (collectively, "**Regulated Entities**") to protect customer information—specifically, the identity of traders and the nature of their trading activities. In particular, these confidentiality protections must explicitly extend to swap transaction data reported to SDRs under the CFTC's data reporting rules. Our concern is not hypothetical; we are aware of instances where the confidentiality of customer trade data at SDRs was compromised. As a result of the failure of confidentiality protections, market participants may have had access to, and could have traded upon, confidential information of competitors and counterparties.

The specifics giving rise to these concerns are best illustrated under the CFTC's final SDR rules, wherein it is clear that an SDR must protect the confidentiality of reported swap data and may not disclose it to market participants. However, the same rules provide an exception to this prohibited access rule, allowing a party to a particular swap to have access to "data and information" related to such swap. The final SDR rules do not define the broad phrase "data and information".

For swaps that are traded anonymously on DCMs and SEFs and then cleared in accordance with the CFTC's straight-through processing requirements, the CCP or DCM/SEF reports the swap transaction data and information to the SDR, which includes the identity of the two original counterparties. If either one of those counterparties is then permitted to discover the identity of the other by accessing information at the SDR, notwithstanding the anonymous nature of the original trade, the confidentiality of that market participant's trading positions and/or investment strategies is breached. Such disclosure would harm competition, and would impair the smooth transition to anonymous trading on DCMs and SEFs.

Another source of data disclosure risk stems from the sheer volume of data that the CFTC is now processing and analyzing from SDRs. While the CFTC's access to such data no doubt presents an opportunity for unprecedented regulatory insight into the derivatives markets – which we support – we are also mindful that it creates another source of disclosure risk if data confidentiality and integrity are not rigorously protected by the CFTC's policies, procedures and internal controls.

Accordingly, MFA recommends that Congress amend the CEA to clarify the CFTC's and each Regulated Entity's obligations to maintain the confidentiality and integrity of swap trade data and the consequences of failures to perform this obligation. MFA further urges the Subcommittee to use its oversight to ensure that both the CFTC and Regulated Entities have appropriate safeguards to preserve the confidentiality of sensitive customer information and data furnished to regulators and Regulated Entities.

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Finally, we are alarmed at reports from this spring that academics have had access to confidential trading data and trading messages from the CFTC. According to these reports, the academic used this information to reverse-engineer trading strategies and published their findings in academic journals. We commend CFTC Chairman Gary Gensler for requesting that the CFTC Inspector General investigate this matter. We believe this disclosure is a fundamental violation of confidentiality and urge the Subcommittee to review the CFTC Inspector General's findings and the steps the CFTC agrees to take to enhance its policies and controls with respect to non-public information.

MFA has prepared a *White Paper* outlining its concerns regarding protection of confidential information and submitted it to all members of the Financial Stability Oversight Council. We include a copy of that *White Paper* as an Appendix to our testimony.

CONCLUSION

MFA appreciates the Subcommittee's focus on, and the CFTC's efforts to enhance, the protection of customers. To further this effort and strengthen these protections, we believe that Congress should encourage the CFTC to finalize the Proposed Rules with certain modifications, amend the Bankruptcy Code to protect cleared swaps customer collateral, encourage the CFTC to repeal the prohibitions in Interp. 10-1 for futures, and provide stronger protections for customers' confidential information. MFA is committed to working with Members and staff of the Subcommittee as well as regulators to ensure that customer protections under our legislative and regulatory system are appropriately robust, extensive and effective.

Thank you for the opportunity to provide you a written statement of MFA's views on customer protection issues. MFA would be happy to answer any questions that you may have.

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