TESTIMONY OF ADVANCE TRADING INC.
TO U.S. SENATE COMMITTEE ON
AGRICULTURE
NUTRITION AND FORESTRY
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My name is Jeffrey Hainline; I am Chairman of Advance Trading Inc. Advance is a large non-guaranteed Introducing Broker that did business with MF Global. Our customers, who are producers, elevators, grain processors, meat producers, covering the full range of U.S. grain industry, along with some international customers, owned about 3,000 accounts there.

I'm sure you can all imagine what recent events have meant to Advance Trading's customers and its business, with large sums still unaccounted for and confusion still afoot more than a month after MF's designation as a Clearing Member was withdrawn.

I am not appearing here to excoriate, recriminate, ventilate, or agitate - rather, to suggest that the Senate Agriculture Committee focus its initial effort on the crucial issue that must be dealt with first. This issue must be resolved in any event, but the need is immediate.

I'll use the grain-elevator business as an example. In the grain industry 100% of each year's supply is produced within a narrow time frame (harvest) and used throughout the full year. So elevators are needed to store that supply for a full year or more. As such, the business is overwhelmingly dominated, like few others, by inventory management and financing. Within each year, the price of inventory fluctuates widely and unpredictably. This necessitates two distinct types of financing - one quantifiable tranche to pay the farmer, and another of unknown size to finance the margin on an equal and opposite position at a futures exchange, so as to neutralize the truly catastrophic price risk inherent.

A typical occurrence is for an elevator to buy grain from producers, simultaneously establish a short futures position to offset, and thereafter profitably warehouse the grain for many months through a sharp advance in price which requires ever-greater financing to maintain the futures short. Depending on market behavior these borrowings can amount to many times the net worth of the elevator corporation. But lenders make funds available at very competitive rates for this purpose because the loan is well-secured by the verifiable presence of the grain in the elevator, and the financial soundness of the futures hedge. The futures market is the essential, central financial instrument on which world grain commerce is entirely based, and *any change in the lender's assessment of risk on what can be an extremely large and rapidly increasing loan balance would alter their financial relationships with grain businesses in dramatic fashion.*

Thus, widespread statements about "missing" money are misleading and threatening to the extraordinarily finance-dependent grain business, if not the entire futures industry. Regardless of whether any specific tranche of money is "missing" or not, each firm's customer segregated capital is guaranteed by the capital of the Clearing Member. Thus far, no statement by the bankruptcy trustee that I have seen seems cognizant of the fact that segregated customer funds are guaranteed by the full capital of the Clearing Member. It is entirely clear to all that that is a precondition of becoming a Clearing Member of the Chicago Mercantile Exchange, and others.

Absent the reality of that guarantee, the business cannot operate.

Additionally, the trustee's performance to-date has been unconscionably slow, for example we understand some customers of foreign exchanges still have not been notified as to prices at which their accounts were involuntarily liquidated. They absolutely can be given that information in short order, yet that is undone after 5 weeks. In this business, every single contract and every single dime is accurately allocated and accounted for on a daily basis. Large corporate bankruptcies like this are often a "go-slow" affair; what I am saying is that the customer accounts and funds portion of MFG cannot be handled in that manner.

So both priority, and rapid execution of the priority, of customer segregated funds in bankruptcies of Clearing Members must occur, *separate* from the potentially years-long unwinding of the multifaceted firm that was MFG. This principle absolutely must be clear for futures exchanges. Futures contracts at the Chicago Mercantile Exchange and other exchanges are rightly regarded by lenders as financially sound *precisely because, and only because,* each Clearing Member guarantees its own capital as *first in line* to back its customers' segregated funds, and the Clearing Corporation guarantees the trades between Clearing Members. Any ambiguity or hesitation as to exactly where those necessary guarantees stand will not only freeze the industry, it will certainly translate into a *sizable multiplier effect in terms of lower prices to farmers, higher prices to consumers, and a substantial impact on world agriculture*. It is not overstating the case to project that if the priority of customer segregated funds in bankruptcy is not firmly entrenched, it will need to be in the wake of MFG, after the effects of not doing so become apparent. *This is an absolutely necessary principle for U.S. agriculture, which is why this Committee must see that it is upheld in what appears thus far to be an unacceptably slow process of repatriation of customer funds.*

As to making changes in the separation between customer seg and proprietary capital, of course first the ongoing forensic examination must be allowed to lay bare what occurred. Thus far, some of us understandably angry and cheated customers have called for separate accounts for each customer and other measures that would add complexity and bureaucracy.

In the end, even if additional restrictions on financial instruments or accounting or other operational measures are proposed, let's not forget a few things:

--That Clearing Members *also* have their capital pledged to their segregated customer funds against the single greatest threat *they themselves* face, which is that their customers defraud or go bankrupt *on them.* This has occurred with relative frequency*, and because the capital of the Clearing Member itself was required to be paid into its customers' seg funds, the other customers were made whole with little if any delay.*

--That new financial techniques will arise thereafter, accounting-rules ambiguity will always foster different opinions, and financial executives will always take innovative steps to maximize returns.

So establishing rules that would have precluded the last problem will not necessarily preclude the next, and may in haste tend toward overkill to assuage those angry at being damaged. I represent my customers' interests, period, and have no particular affection for CME or its business model. But the Exchanges we deal with, primarily CME, have the greatest abiding interest of anyone in the solvency of their clearing members, the security and good will of customers, and the trust of fiduciaries that lend large sums to both. The CME above all others cannot chance ever having this occur again, and it also has more financial acumen and practical experience than anyone pertaining to all participants that make up its business community. While CFTC and this Committee will examine what it does carefully, CME together with the other regulated exchanges must propose any necessary changes. The CFTC should then approve or suggest further adjustments that the exchanges analyze and results in the needed changes. If the Exchanges err, it might result in far greater damage to, or even failure of, their operations. That tends to concentrate their minds rather more than does the incentives or motives of other parties.

By concentrating its first efforts on expediting the unwinding of the current financial snarl affecting a substantial portion of U.S. agriculture, this Committee can make the greatest contribution to all its agricultural constituents and consumers too. It must use its authority and expertise to clarify the bankruptcy status of Futures Clearing Members' responsibility to their customers' segregated funds, which is the only way the futures industry at the financial heart of U.S. agriculture can possibly operate. That is the largest and most pressing issue in the failure of MFG.

We need:

- **to protect our efficient system**
- **to be vigilant for possible corruption**
- **to send a strong signal of deterrence**

- **<u>RESTITUTION of all segregated funds</u>**
- **<u>AND REFORM of our system to prevent abuse</u>**