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TESTIMONY OF THE

NATIONAL GRAIN AND FEED ASSOCIATION

TO THE

COMMITTEE ON AGRICULTURE

UNITED STATES SENATE

AUGUST 1, 2012

Good morning, Chairman Stabenow, Ranking Member Roberts, and members of the committee. I am Diana Klemme, Vice President and Director of the Grain Division at Grain Service Corporation, an Introducing Broker based in Atlanta, Georgia. GSC provides brokerage services to businesses and individuals hedging agricultural price risk, as well as advisory and educational services to clients and other firms. Our clients include country grain elevators, farmers and end-users of commodities.

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

I serve on the NGFA's Risk Management Committee, as well as its MF Global Task Force, formed to develop recommendations in the aftermath of the failure of MF Global. Our priorities are to advocate regulatory and policy changes that will help ensure that another similar situation does not recur, and to enhance protections for commodity futures customers.

Many NGFA-member firms have been affected deeply by the MF Global Holdings bankruptcy and the subsequent liquidation of futures commission merchant (FCM) MF Global Inc. Following the bankruptcy, customers' accounts were frozen, and then transferred to other FCMs in a chaotic fashion and with a dearth of information to help customers manage their financial exposure. Today, another distribution of funds from the MF Global trustee is underway with the goal of bringing all commodity customer distributions to about 80 percent of account value.

However, many firms still have received only 72 percent of their funds with no assurance they ever will be made whole.

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

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

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

We still are awaiting details of the situation surrounding the PFG situation. On its face, the PFG failure appears to have some key differences from MF Global – namely, that customer funds were intentionally misappropriated for a variety of illegitimate purposes over a very long period of time. However, the cumulative effect of MF Global and PFG failures occurring within a relatively short time – and especially the failure of PFG at a time when regulators presumably were on heightened alert for problems – has been a huge loss of confidence in regulators and in the adequacy of current rules to protect customer funds. This failure of two firms in nine months – with massive financial loss to customers – is incomprehensible and demands immediate change. We look forward to a full explanation by regulators of exactly what happened at PFG. In the meantime, we believe there are steps that should be taken to begin restoring confidence and to bolster protections for segregated customer funds. The loss of customer confidence in the system is the most critical and urgent issue that must be addressed.

To better illustrate why the loss of confidence in the present system of managing customer funds is urgent and unsustainable, I would like to use as an example GSC's core client base: the typical country elevator. Country elevators, large and small, buy grain from farmers and sell futures against that ownership. These hedges eliminate price risk until the grain is received, aggregated and sold to exporters, feedlots or other domestic buyers – typically in larger volumes. Hedging provides a vital service to agriculture – buying when farmers want to sell and selling when the end buyer needs the commodity.

Elevators also buy commodities that farmers want to price for future crops. Forward contracts can allow the farmer to buy land and inputs with greater confidence, knowing their production is priced, at least in part. The elevator may have to hold and maintain these short futures hedges a year or more and be financially able to meet any margin calls if prices rise. Consider an actual typical country elevator that currently holds the following futures positions:

Corn	short 620 futures contracts	= 3,100,000 bushels
Soybeans	short 100 futures contracts	= 500,000 bushels
Wheat	short 120 futures contracts	= 600,000 bushels
	Short Total	**= 4.2 million bushels of open short futures**

As of Friday, July 20:	
Open Trade Equity (7/20/12)	= ($7.5 million) Mark to market 'loss' [1]
Initial Margins	= $1.9 million held on deposit at FCM
Total Funds sent to the FCM	= **$9.4 million** (equivalent to $2.24 per bushel)

[1] Based on the original futures sale price(s) marked to the close on 7/20/2012.

This elevator now has had to send a total of $9.4 million in Initial and Variation margin calls into a system where no one any longer can assure them those funds are 100 percent safe. This customer has met every margin call immediately – a huge act of faith when this business still is hoping for the final recovery of funds missing in the collapse of MF Global. Further, agricultural hedgers and others rely on their lenders to provide much of the financing for these margin calls.

Corn and soybean prices already have hit record highs this summer. Now, this country elevator must ***continue*** to hold short futures hedges until the grain is received and sold, and hedges can be lifted. The firm has sent $9.4 million and the manager must be prepared to ask the lender for, and send more money, as long as market prices continue to increase. Conversely, if futures prices decline, this elevator may show substantial 'mark-to-market' gains on futures day-to-day. The hedger needs to know those funds actually will be available to withdraw upon demand.

This is but one small example. Multiply it by the aggregate size of U.S. agriculture and one can envision the scope of the financial demands and exposure on owners and managers of thousands of businesses that use futures to reduce risk.

NGFA's Recommendations

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

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

Reforms to the U.S. Bankruptcy Code

The NGFA believes that a number of revisions in the U.S. bankruptcy code would provide greater protection for commodity futures customers. Briefly, we would like to see various provisions of the Commodity Exchange Act, CFTC regulations and the bankruptcy code harmonized to provide greater clarity and avoid interpretive inconsistencies. The NGFA also would like to see the code revised to strengthen CFTC authority to appoint a trustee and to state clearly that customers always should be first in line for distribution of funds in a liquidation. Commodity customer committees should be authorized to represent commodity customers' interests, and "safe harbor" bankruptcy provisions should be revised so as not to limit a trustee's ability to recover customer funds.

The NGFA's recommendations are described in more detail in the attached letter, and we would welcome the opportunity to work with the committee, regulators and stakeholders to move bankruptcy code reforms forward as expeditiously as possible.

Fully Segregated Customer Accounts

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

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

Insurance for Commodity Futures Customer Accounts

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

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