STATEMENT OF COMMISSIONER JILL E. SOMMERS
COMMODITY FUTURES TRADING COMMISSION
BEFORE THE
UNITED STATES SENATE
COMMITTEE ON AGRICULTURE
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Good afternoon Chairwoman Stabenow, Ranking Member Roberts, and members of the Committee. Thank you for inviting me today to discuss the MF Global Bankruptcy. I understand the severe hardship this bankruptcy has caused for customers of MF Global. These customers correctly understood the risks associated with trading futures and options, but never anticipated that their segregated accounts were at risk of suffering losses not associated with trading. Many customers have reached out to me and my staff directly, and we are doing everything we can to get as much of their money back to them as quickly as possible. I have made that my number one priority.

On November 9th, the Commission voted to make me the Senior Commissioner with respect to MF Global Matters. This authorizes me to exercise the executive and administrative functions of the Commission solely with respect to:

- The pending enforcement investigation;
- The pending bankruptcy case in the Southern District of NY involving MF Global, Inc. (which is the broker-dealer/futures commission merchant);
- The pending bankruptcy case in the Southern District of NY involving MF Global Holdings, Ltd. (which is the parent company); and

- Other actions to locate or recover customer funds or determine the reasons for shortfalls in the customer accounts.

The Commission has dozens of staff members (including auditors, attorneys, and investigators) in New York, Chicago, and Washington, D.C. working on these issues. I am unable to discuss matters that might compromise the ongoing enforcement investigation or parallel investigations by any other government agency, so I will focus my comments on the bankruptcy cases pending in New York and on the legal requirements surrounding the segregation of customer funds held at futures commission merchants (FCMs).

Pending Bankruptcy Cases

As I understand the Securities Investors Protection Act of 1970 (SIPA), the SEC has the authority to refer an entity registered as a broker-dealer (whether or not such entity is also registered as an FCM) to the Securities Investors Protection Corporation (SIPC) if there is reason to believe that the entity is in or is approaching financial difficulty. SIPC may initiate a liquidation proceeding to protect customers of an insolvent broker-dealer when certain statutory criteria are met. In this instance, the liquidation was initiated on October 31st, with the support of the CFTC and consent of MF Global. When a broker-dealer is also a registered FCM, as MF Global was, there is one dually-registered entity and the entire entity gets placed into liquidation. Because there is one entity, it is not possible to initiate a SIPA liquidation of the broker-dealer, and a separate bankruptcy proceeding for the FCM. It is important to note, however, that when a dually-registered BD/FCM is placed into a SIPA liquidation proceeding, the relevant provisions and protections of the Bankruptcy Code, the Commodity Exchange

Act ("CEA"), and the Commission's regulations apply to commodity accounts just as they would if the entity were solely an FCM and in a non-SIPA bankruptcy proceeding.

An obvious point to make is that if a firm is involved in a bankruptcy proceeding, something must have gone very wrong. Bankruptcy proceedings can be very complicated and at times, messy. This can be magnified when the bankruptcy is among the largest in history and there are serious questions about the location of customer funds. The Commission is no stranger to FCM bankruptcies. Lehman Brothers and Refco are the two most recent FCM bankruptcies. While the Lehman Brothers bankruptcy was monumental in scale, and the Refco bankruptcy involved serious fraud at the parent company, commodity customers did not lose their money at either firm. In both instances, commodity customer accounts were wholly intact, that is, they contained all open positions and all associated segregated collateral. That being the case, customer accounts were promptly transferred to healthy FCMs, with the commodity customers having no further involvement in the bankruptcy proceeding. Unfortunately that is not what happened at MF Global because customer accounts were not intact.

In FCM bankruptcies, commodity customers have an exclusive right to customer property. This includes, without limitation, segregated property, property that was illegally removed from segregation and is still within the debtor's estate, and property that was illegally removed from segregation and is no longer within in the debtor's estate, but is clawed-back into the debtor's estate by the Trustee. If the customer property as I just described is insufficient to satisfy in full all the claims of customers, Part 190 of the Commission's regulations allow other property of the debtor's estate to be classified as customer property to make up any shortfall. A parent or affiliated entity, however, generally would not be a “debtor” unless customer funds could be traced to that entity.

Within the first weeks of the MF Global bankruptcy, the Trustee for the BD/FCM had, with the encouragement and assistance of the CFTC, transferred nearly all positions of customers trading on U.S. commodity futures markets, and transferred approximately $2 billion of customer property. On November 29th, the Trustee moved to transfer an additional $2.1 billion back to customers, to be used to “top up” all commodity customers to at least two-thirds of their account values as reflected on the books and records of MF Global, Inc. The Commission fully supported the Trustee’s motion. Last Friday, the Bankruptcy Court granted the motion, and it appears that the “top up” amount will be closer to 72%. The additional $2.1 billion transfer is expected to be completed within two to four weeks. The transfers to date demonstrate that commodity customers are receiving the highest priority in claims to the bankruptcy estate. Nonetheless, we understand that more must be done.

<u>FCM Investment of Customer Funds</u>

An FCM is authorized to invest funds that are in customer segregated accounts. This authorization is found in Section 4d of the CEA and in Commission Regulation 1.25 (a brief history of changes to Regulation 1.25 is found in the attached Appendix). Regulation 1.25 only relates to how an FCM can invest customer funds. Moreover, any losses that may occur as a result of those permissible investments are the responsibility of the FCM, not the customer. Prior to last week, Regulation 1.25 allowed an FCM to invest customer funds in highly-rated foreign sovereign debt, but the investment was strictly limited to the amount of that nation’s foreign currency a customer posted to the

FCM. Regulation 1.25 does not, and has never, had anything to do with investments that an SEC/FINRA-regulated BD makes for its own account.

In thinking about the investment of customer funds, it may be helpful to draw an analogy to a savings account at a bank. Let's say someone opens a savings account with $1,000 and the bank agrees to pay 0.25% interest annually. That $1,000 is not just sitting at the bank waiting for the depositor to come and get it. The bank invests that money, or loans it to others, etc., with the goal of earning a rate of return greater than the 0.25% interest the bank is obligated to pay the depositor. Very simply stated, if the bank earns a rate of return greater than 0.25%, that is net revenue for the bank. If the bank earns a rate of return less than 0.25%, there is a net loss.

Broadly speaking, the investment of customer funds by an FCM is similar, but there are critical safeguards and restrictions placed on FCMs. Section 4d of the CEA and Commission Regulation 1.25 list the only permissible investments an FCM can make with customer funds. The Commission has been, and continues to be, mindful that customer segregated funds must be invested in a manner that minimizes their exposure to credit, liquidity, and market risks both to preserve their availability to customers and DCOs and to enable investments to be quickly converted to cash at a predictable value. As such, Regulation 1.25 establishes a general prudential standard by requiring that all permitted investments be "consistent with the objectives of preserving principal and maintaining liquidity."

While an FCM is permitted to invest customer funds, it is important to note that if an FCM does so, the value of the customer segregated account must remain intact at all times. In other words, when an FCM invests customer funds, that actual investment, or collateral equal in value to the investment, must remain in the customer segregated account at all times. If customer funds are transferred out of the segregated account to be invested by the FCM, the FCM must make a simultaneous transfer of assets into the segregated account. An FCM cannot take money out of a segregated account, invest it, and then return the money to the segregated account at some later time.

Customer Accounts at FCMs

When a customer opens a trading account at an FCM, Commission Regulations require the customer to be provided with a risk disclosure statement that generally centers on market risk, market volatility, and leverage. Pursuant to Commission Regulation 1.55(b)(6), the required risk disclosure statement must also include the following: "You should consult your broker concerning the nature of the protections available to safeguard funds or property deposited for your account." There are no required disclosures concerning how customer funds can be invested by an FCM.

Commission Regulation 1.20 requires that accounts holding segregated funds be titled specifically to identify the contents of the account as separate from the ownership of the FCM. In addition, FCMs must obtain letters from their depositories acknowledging that the depositories cannot exercise any rights of offset to such accounts for obligations of the FCM.

Commission Regulation 1.12 requires FCMs to notify the Commission immediately of an occurrence of under-segregation. FCMs also must notify the Commission of instances of significant margin calls (such as a margin call to a customer, which if not made, would put fellow customers at risk if an adequate buffer or "excess segregation" was not in segregated accounts).

A customer is required to post margin to support futures positions. Generally, a customer deposits more than the minimum initial margin required for the positions established. The additional funds provide a buffer so a customer can place trades without posting additional margin, and lessen the likelihood of repeated margin calls or having positions liquidated if margin calls are not met on a timely basis. In addition to customers depositing additional margin, in practice, FCMs typically maintain significant amounts of their own capital as “excess segregated funds.” By doing this, one customer’s deficit due to market moves or unmet margin calls is covered by the FCM’s buffer and does not result in one customer’s funds being exposed to the credit risk of another customer. FCMs are not obligated to provide excess segregated funds, but given the legal obligation at all times to have sufficient funds in segregated accounts to cover all liabilities to customers, FCMs generally find it wise to have a buffer.

A customer may withdraw excess margin funds or use such funds as the customer deems appropriate. This would include using the funds for non-futures related transactions with the FCM. If the excess funds held by the FCM are used in a manner directed by the customer such that the funds are not maintained in a futures segregated account, the funds would not have the protections afforded segregated customer funds under the Bankruptcy Code and Part 190 of the Commission’s Regulations.

Oversight of FCMs

FCMs are subject to CFTC-approved minimum financial and reporting requirements that are enforced in the first instance by a designated self-regulatory organization (“DSRO”), for example, the Chicago Mercantile Exchange or the National Futures Association. DSROs also conduct periodic compliance examinations on a riskbased cycle every 9 to 15 months. The requirements of DSRO examinations are contained in Financial and Segregation Interpretations 4-1 and 4-2, which are specified as application guidance to Core Principle 11 (Financial Integrity) for Designated Contract Markets. The Commission has proposed codifying the essential components of these interpretations into an amended Commission Regulation 1.52.

An examination of segregation compliance is mandatory in each examination (certain other components need not be included in every examination). This examination includes a review of the depository acknowledgement letters and the account titles of segregated accounts (unless unchanged from the prior examination); verifying account balances, and ensuring that investment of customer funds is done in accordance with Commission Regulation 1.25.

Commission Regulation 1.10 requires FCMs to file monthly unaudited financial reports with the Commission and the DSRO. These reports include the FCM's segregation and net capital schedules, and any "further material information as may be necessary to make the required statements and schedules not misleading." Each financial report must be filed with an oath or attestation, and for a corporation, the oath must be by the CEO or CFO.

Commission Regulation 1.16 requires FCMs to file annual certified financial reports with the Commission and the DSRO. The audits require, among other things, that if a new auditor is hired, that new auditor is required to notify the Commission of certain disagreements with statements made in reports prepared by prior auditors. Auditors also must test internal controls to identify, and report to the Commission, any "material inadequacy" that could reasonably be expected to: inhibit a registrant from completing transactions or promptly discharging responsibilities to customers or other creditors; result in material financial loss; result in material misstatement of financial statements or schedules; or result in violation of the Commission's segregation, secured amount, recordkeeping or financial reporting requirements.

Conclusion

While our current focus is returning as much money as possible to customers, we are expending an enormous amount of effort to locate the missing customer funds and pursuing the enforcement investigation. All of the information we learn during these aspects of our work will be relevant to the Commission as it considers "lessons learned" and any policy responses or regulatory changes. It is just too early to tell, however, what responses and/or changes the Commission will find appropriate.

Obviously, the Commission has a great deal of work ahead of it to get customer funds back where they need to be, to determine what went wrong with segregated funds at MF Global, to determine whether to prosecute any violations of the Act, and to determine what needs to be done to prevent a similar circumstance in the future. Commission staff is coordinating on these issues with sister regulators both domestically and overseas, and is working closely with the SIPA Trustee to provide whatever support he needs to resolve issues with commodity customer accounts. I greatly appreciate the continued support of this Committee as we move forward with this important work.

Thank you. I am happy to answer any questions you may have.

Appendix

Under Section 4d of the CEA, customer segregated funds may be invested in:

- obligations of the United States and obligations fully guaranteed as to principal and interest by the United States (U.S. government securities); and
- general obligations of any State or of any political subdivision thereof (municipal securities).

Pursuant to Section 4(c) of the CEA, in December 2000 the Commission expanded the list of permitted investments by amending Regulation 1.25 to permit investments in:

- general obligations issued by any enterprise sponsored by the United States (government sponsored enterprise or GSE debt securities);
- bank certificates of deposit (CDs);
- commercial paper;
- corporate notes;
- highly-rated foreign sovereign debt (**but the investment is strictly limited to the amount of that nation's currency the customer posts as collateral to the FCM**); and
- interests in money market mutual funds (MMMFs).

In connection with that expansion, the Commission included several provisions intended to control exposure to credit, liquidity, and market risks associated with the additional investments, e.g., requirements that the investments satisfy specified rating standards and concentration limits, and be readily marketable and subject to prompt liquidation.

In February 2004, the Commission adopted amendments to Commission Regulation 1.25 regarding:

- repurchase agreements using customer-deposited securities and time-to-maturity requirements for securities deposited in connection with certain collateral management programs of DCOs.

In May 2005, the Commission adopted amendments to Commission Regulation 1.25 regarding:

- standards for investing in instruments with embedded derivatives;
- requirements for adjustable rate securities;
- concentration limits on reverse repurchase agreements;
- transactions by FCMs that are also registered as securities brokers or dealers (in-house transactions);
- rating standards and registration requirements for MMMFs;
- an auditability standard for investment records; and
- certain other technical changes.

In 2007, the Commission's Division of Clearing and Intermediary Oversight (Division) launched a review of the nature and extent of FCM investment of customer funds in order to further its understanding of investment strategies and practices and to assess whether any changes to the Commission's regulations would be appropriate. As part of this review, all registered Derivatives Clearing Organizations (DCOs) and FCMs carrying customer accounts provided responses to a series of questions. As the Division was finalizing its review of materials submitted by DCOs and FCMs, and conducting follow-up interviews with them, the market events of September 2008 occurred and changed the financial landscape such that much of the data previously gathered no longer reflected current market conditions.

In May 2009, the Commission issued an advance notice of proposed rulemaking to solicit comment prior to proposing amendments to the list of permitted investments. The Commission sought comments, information, research, and data regarding regulatory requirements that might better safeguard customer segregated funds. It also sought comments, information, research, and data regarding the impact of applying the requirements of Regulation 1.25 to 30.7 funds (30.7 refers to funds of foreign futures and options customers). The Commission received twelve comment letters - eleven supported maintaining the list of permitted investments and/or ensuring that MMMFs remained permitted investments; five focused solely on the topic of MMMFs, providing detailed discussions of their usefulness to FCMs; and several addressed issues regarding ratings, liquidity, concentration, and portfolio weighted average time to maturity.

In October, 2010, the Commission proposed changes to the list of permissible investments, and on December 5, 2011 adopted final rules in that regard. The final rules, among other things:

- retain U.S. agency obligations, including implicitly backed GSE debt securities, but allow investment in debt issued by Fannie Mae and Freddie Mac only as long as they operate under the conservatorship or receivership of FHFA;
- remove corporate debt obligations not guaranteed by the United States;
- eliminate foreign sovereign debt;
- eliminate in-house and affiliate transactions; and
- impose asset-based concentration limits on various investments.