

Testimony Before the U.S. House of Representatives Subcommittee on Oversight and Investigations of the Committee on Financial Services

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Good afternoon Chairman Neugebauer, Ranking Member Capuano, and members of the Subcommittee. I am Dan Berkovitz, the General Counsel at the Commodity Futures Trading Commission. Thank you for the opportunity to testify today regarding MF Global. The Commission is acutely aware of the impact MF Global's bankruptcy has had on customers, who have found themselves without access to their funds through no fault of their own. Our highest priority at this time is returning money that belongs to the customers back to them as quickly as possible. The Commission is working diligently to determine what happened to and locate the missing customer funds. The Commission has dozens of dedicated staff in Chicago, New York, and Washington working on these issues.

My testimony today will provide an update on the efforts to return customer money through the bankruptcy proceeding and an overview of the Commission's regulation of futures commission merchants (FCMs), including MF Global, with particular focus on the regulations for the protection of customer funds. I am unable to discuss matters today that might compromise any ongoing investigations.

Efforts to Return MF Global Customer Money

On October 31, the Securities Investor Protection Corporation (SIPC), with the support of the CFTC and consent of MF Global, initiated a liquidation proceeding under the Securities Investors Protection Act of 1970 (SIPA) to protect the customers of MF Global. In FCM bankruptcies, commodity customers have, pursuant to Section 766(h) of the Bankruptcy Code,

priority in 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 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 allows 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 MF Global, 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 December 9, the Bankruptcy Court granted a motion to transfer an additional \$2.2 billion back to customers. When this additional transfer goes forward, commodity customers should have received approximately seventy-two percent of their account values as reflected in the books and records of MF Global.

Oversight of FCMs

An FCM is an entity that (1) solicits or accepts orders for the purchase or sale of commodity future contracts; and (2) accepts money, securities, or property to margin, guarantee, or secure any resulting trades.

Because FCMs hold customer money, they are subject to minimum financial and reporting requirements pursuant to the Commodity Exchange Act (CEA or Act) and Commission Regulations. Front line oversight of these requirements is carried out by designated self-regulatory organizations (DSROs), such as the National Futures Association or the Chicago

Mercantile Exchange (CME). The CME is the DSRO for all FCMs that are members of its derivatives clearing organization. Section 5(d)(11) of the Act, or Core Principle 11 for Designated Contract Markets, provides that a DCM shall establish and enforce rules to ensure the financial integrity of FCMs and the protection of customer funds. The Commission's Application Guidance for Core Principle 11 requires that every FCM be examined by its DSRO once every 9 to 15 months.

Each examination must include a review of the FCM's compliance with capital and customer funds segregation requirements. The examination includes a review of the depository acknowledgement letters and the account titles of segregated accounts, verification of account balances, and a review to assess whether investment of customer funds is done in accordance with Commission Regulations (1.25).

Commission Regulation 1.10 requires that each FCM submit to the Commission and to each self-regulatory organization (SRO) of which the FCM is a member, an annual financial report, certified by an independent public accountant. The report must include a Commission designed statement of computation of the minimum capital requirement and a statement of segregation of customer assets. Auditors 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. The annual reports are reviewed by staff of the Commission's Division of Swaps and Intermediary Oversight (DSIO) as well as the SROs.

In addition to the audited annual report requirement, each FCM is also required by Regulation 1.10 to file monthly unaudited financial reports with the Commission and with each SRO of which the FCM is a member. The CFTC's financial report is Form 1-FR-FCM. An FCM that is also a registered broker or dealer may instead file the Focus Report required of broker dealers by the SEC. Both the CFTC and the SEC financial forms include a statement of financial condition and a statement of segregated funds. The monthly form must be signed by either the Chief Executive Officer or the Chief Financial Officer.

The DSRO of a particular FCM is responsible for the primary review of the FCM monthly financial statements. The Reports are received by the Commission electronically and are subject to automated edit checks. A review of the edit checks is performed by staff of DSIO. FCMs are required to be in compliance with the minimum capital requirements at all times, but are normally only required to prepare and maintain a formal computation once a month.

DSIO staff conducts limited scope examinations of FCMs either as part of the assessment of the DSRO's examination function or on a "for cause" basis. DSIO has approximately 45 staff who work on the examinations for all intermediaries, including FCMs. Their FCM reviews generally focus on specific issues at the firm, and may include capital and segregation reviews.

The assessments of the DSRO's examination function consist of reviews to determine whether DSROs are conducting their examinations in accordance with the Commission's Application Guidance for Core Principle 11.

Customer Protection Rules for FCMs

When a customer opens a trading account at an FCM, the FCM must provide a risk disclosure statement regarding market risk, volatility, and leverage. The risk disclosure must

contain the following statement: “You should consult your broker concerning the nature of the protections available to safeguard funds or property deposited in your account.”

Under the Commodity Exchange Act, an FCM must treat all money securities and property received from a customer as margin for the trades or contracts of that customer as belonging to that customer. Furthermore, all customer money, securities, and property must be separately accounted for and segregated from the FCM’s proprietary funds. The FCM cannot use funds deposited by one customer to margin or secure trades for another customer.

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 funds deposited in those accounts are customer funds and must be treated as such under the CEA—i.e., such depositories are prohibited from treating them as belonging to the FCM or any person other than the customer.

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

Each customer posts margin to support futures positions. Often, a customer will maintain an account balance in excess of initial margin required. 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 liquidation of positions if margin calls are not timely met. In addition to customers depositing additional margin, in practice, FCMs typically maintain significant

amounts of their 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 generally do so to assure their compliance with the legal obligation at all times to have sufficient funds in segregated accounts to cover all liabilities to customers.

A customer may withdraw excess margin funds or use such funds as the customer deems appropriate. This includes 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.

Investment of Customer Funds

An FCM is authorized to invest funds that are in customer segregated accounts by Section 4d of the Commodity Exchange Act and Commission Regulation 1.25. These provisions list the types of investments that FCMs can make with customer funds. Section 4d states that customer segregated funds may be invested in obligations of the United States, obligations fully guaranteed as to principal and interest by the United States, and 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 government sponsored enterprise debt securities, bank certificates of deposit, commercial paper, corporate notes, general obligations of a sovereign nation (only where the FCM holds customer funds in that sovereign nation’s currency), and money market mutual funds. 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 additional amendments 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, rating standards and registration requirements of money market mutual funds, an auditability standard for investment records, and other technical changes.

On December 5, 2011, the Commission adopted a new final Regulation 1.25. The new Regulation 1.25 continues to permit investment in obligations of the United States, obligations fully guaranteed as to principal and interest by the United States, municipal securities, United States agency obligations, certificates of deposit, commercial paper and corporate notes or bonds fully guaranteed by the United States under the Temporary Liquidity Guarantee Program administered by the Federal Deposit Insurance Corporation, and money market mutual funds. The new Regulation 1.25 does not allow customer segregated funds to be used in the following types of investments or transactions that were previously permitted: foreign sovereign debt, internal and inter-affiliate repurchase transactions, and commercial paper and corporate notes and bonds not guaranteed by the United States under the Temporary Liquidity Guarantee Program. The new rule also imposes asset-based and issuer-based concentration limits on various investments.

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. This preserves the availability of the funds to customers and DCOs and enables the investments

to be quickly converted to cash at a predictable value. Regulation 1.25 provides that customer funds are to be invested “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 the segregated account, invest it, and then return the money to the segregated account at some later time.

Conclusion

The Commission continues to focus on returning MF Global customer funds, in addition to determining how and why the funds went missing. Thank you for the opportunity to address the Subcommittee. I’d be happy to answer any questions you may have.