STATEMENT OF COMMISSIONER JILL E. SOMMERS
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BEFORE THE
UNITED STATES SENATE
COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS
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Good morning Chairman Johnson, Ranking Member Shelby, and members of the Committee. Thank you for inviting me today to discuss the collapse of MF Global, lessons learned, and policy implications. Over the past five and a half months the Commodity Futures Trading Commission has conducted a thorough analysis of the books and records of MF Global and continues to work closely with the Trustee in the SIPA bankruptcy proceeding to recover customer funds. We are also engaging in a comprehensive and ongoing enforcement investigation. It is imperative that the Commission, the industry, and the Congress identify and assess the causes for the collapse and shortfall in customer funds and to take corrective action where possible. Chairman Gensler has directed Commission staff to develop recommendations for enhancing Commission and designated self-regulatory organization (DSRO) programs related to the protection of customer funds, which could include changes to Commission rules governing futures commission merchants (FCMs), enhanced Commission oversight of DSROs, and possible statutory changes, among other things. We must do everything in our power to restore confidence in the futures markets so that producers, processors and other end-users of commodities can once again hedge their price risks without fear of their funds being frozen or lost.

On November 9, 2011, 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 bankruptcy proceedings, and other actions to locate or recover customer funds or determine the reasons for shortfalls in the customer accounts. While Mr. Giddens and Mr. Freeh are here to discuss the bankruptcy proceedings, I would like to provide some background on why the claims of MF Global's commodity customers are in a Securities Investment Protection Act proceeding.

SIPA Proceedings

Under the Securities Investors Protection Act of 1970 (SIPA), the Securities and Exchange Commission (SEC) has the authority to refer an entity registered as a broker-dealer (BD) to the Securities Investors Protection Corporation (SIPC) if there is reason to believe that the BD is in or is approaching financial difficulty. SIPC may initiate a liquidation proceeding to protect customers of an insolvent BD when certain statutory criteria are met. When a BD 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 for the BD 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 or Act) and the Commission's regulations apply to the claims of commodity customers just as they would if the entity were solely an FCM and in a non-SIPA bankruptcy Proceeding.

Current Protections for Customer Funds

Section 4d of the CEA and Commission regulations require an FCM holding customer funds to treat such funds as belonging to the customer at all times and to segregate from its own funds any money, securities or property deposited by its customers to margin, guarantee, or secure futures or options positions entered into on Commission designated contract markets (Section 4d funds). FCMs are prohibited from using a customer's funds to margin or guarantee the trades or contracts of another customer, or of the FCM. The FCM may, however, commingle the funds of one futures customer with funds belonging to other futures customers in a single account or accounts. The FCM is required to maintain sufficient funds in segregated accounts to cover the net liquidating equity (i.e., total account balances due) of each of its customers at any given point in time.

The Act and regulations also require an FCM to hold in separate accounts (designated as "Part 30 secured accounts") customer funds deposited for trading futures and options listed on foreign boards of trade. The FCM may commingle the foreign futures funds deposited by one customer with the funds deposited by other foreign futures customers. An FCM may not, however, commingle Section 4d funds with Part 30 secured account funds. Under Part 30, an FCM must hold funds sufficient to meet the margin required on open futures and option positions, plus any unrealized gains, or minus any unrealized losses, on the open positions. The FCM is not required to hold in Part 30 secured accounts funds sufficient to cover the net liquidating equity of each foreign futures customer as it must for Section 4d accounts.

When a customer opens a trading account with an FCM, Commission regulations require the FCM to provide the customer with a risk disclosure statement that generally centers on market risk, market volatility, and leverage. Disclosures concerning how customer funds can be invested by an FCM are not currently mandated, but Commission Regulation 1.25 lists permitted investments and establishes a general prudential standard that requires that any investment of customer funds be "consistent with the objectives of preserving principal and maintaining liquidity." Section 4d and Commission Regulation 1.25 require that the value of customer segregated accounts remain intact at all times.

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 right of offset to such accounts for obligations of the FCM. Regulation 1.20 depositories cannot hold, dispose of, or use customer funds for anyone other than the customer who deposited such funds.

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

Customers are required to post margin to support their futures and option 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 positing 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 to have sufficient funds in segregated accounts at all times 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 segregated or secured account, the funds would not have the protections afforded customer funds under the Bankruptcy Code and Part 190 of the Commission's regulations.

FCMs are also free to withdraw excess funds in Section 4d accounts deposited by and belonging to the FCM. At no time, however, may an FCM withdraw funds belonging to customers from a Section 4d account, use those funds for its own purposes, and replace them at a later date.

Oversight of FCMs

FCMs are subject to CFTC-approved minimum financial and reporting requirements that are enforced in the first instance by a DSRO, for example, the Chicago Mercantile Exchange (CME), or the National Futures Association (NFA). DSROs also conduct periodic compliance examinations on a risk-based 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 customers 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, secured 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 Chief Executive Officer or the Chief Financial Officer.

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, the 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.

Coordination among Regulators for Dually-Registered BD-FCMs

The Act and Commission regulations establish a regulatory structure where front-line financial regulation is performed by the DSROs. As mentioned, the CME and the NFA are the two primary futures market DSROs. Generally speaking, the CME has primary financial surveillance responsibilities over FCMs that are clearing members of the CME, and NFA has primary financial surveillance responsibilities over other FCMS, including non-clearing FCMs and retail foreign exchange dealers.

Many FCMs are also registered with the SEC as BDs. These dually-registered BD-FCMs are subject to the jurisdiction of both the CFTC and the SEC. The CFTC focuses primarily on the futures activities of dual-registrants, while the SEC focuses primarily on their securities activities.

To better ensure that all activities of a BD-FCM are properly reviewed, futures and securities regulators, including self-regulatory organizations (SROs), coordinate their oversight efforts. This coordination includes periodic meetings of the Inter-Market Financial Surveillance Group (IFSG), which is comprised of the CFTC, the SEC, and

futures and securities markets SROs. The IFSG generally meets two to three times each year to discuss emerging regulatory issues, including rule amendments that impact financial or operational requirements for FCMs and BDs, and changes to business operations. The IFSG meetings also provide a platform for securities and futures regulators to discuss upcoming examination priorities.

Futures and securities SROs also share information regarding dual-registrants as part of the examination program. For example, prior to conducting an examination of a dually-registered BD-FCM, the futures market DSRO will contact the securities market SRO for the purpose of obtaining an understanding of any issues or concerns that the securities SRO may have with the firm, either as a result of a current event or as part of the securities SRO's previous examination. The information obtained by the futures market DSRO would be used in setting the scope of its examination of the FCM. The futures and securities SROs also share their examination reports of dually-registered entities.

MF Global was a dually-registered BD-FCM, and therefore was subject to the jurisdiction of both the CFTC and the SEC. The CME was the DSRO for MF Global's futures market activities, and had primary responsibility for overseeing the FCM's compliance with the capital, segregation and financial reporting obligations required by the CFTC. The Chicago Board Options Exchange (CBOE) and the Financial Industry Regulatory Authority (FINRA) were the SROs for MF Global's securities market activities, and had primary responsibility for overseeing the BD's compliance with securities regulations.

Prior to the bankruptcy, the futures and securities regulators shared information and examination results as described above. In August 2011, MF Global filed revised financial statements and regulatory notices with the CFTC as a result of additional capital charges that FINRA and the SEC required the BD to take on certain repo to maturity transactions on foreign sovereign debt, which was activity overseen by the SEC and FINRA. At approximately the same time, SEC staff contacted CFTC staff to inform them of the capital charges. CFTC staff also consulted with the CME, FINRA, and the CBOE regarding the imposition and rationale for the additional securities capital charges. The additional capital charges caused MF Global to fall below CFTC minimum capital requirements, which the firm immediately addressed by contributing additional capital to the FCM.

Commission staff also consulted with FINRA and the CME during the period of October 24 through October 31, 2011. During these calls futures regulators and securities regulators provided information on the status of MF Global from their regulatory perspectives. These discussions focused on various issues, including the impact of the credit rating downgrades and reported losses of $186 million for the quarter ending September 30, 2011. The purpose of these discussions included sharing information regarding the firm's financial condition and potential liquidity issues and sources of funding, and the fact that the reported earnings and credit rating downgrade did not appear to cause a significant number of futures customers to seek to

transfer their accounts during the early part of the week of October 24, 2011. Commission staff also participated on calls with the Joint Audit Committee, a committee comprised of futures exchanges and clearing organizations, commencing on October 27, 2011. The exchanges informed Commission staff that MF Global was meeting all of its financial obligations to the respective clearing organizations and that the futures markets had not imposed additional margin or capital requirements on MF Global. The exchanges indicated that some customers were now transferring their accounts out of MF Global.

Commission staff also consulted with the SEC and FINRA in the hours leading up to the bankruptcy filing on October 31, 2011, when, as it acknowledged, MF Global was in violation of Section 4d of the Act and Commission regulations for failing to maintain sufficient funds in segregation to cover the account equities of each customer.

Strengthening Protections for Segregated Customer Assets

In the aftermath of MF Global, Commission staff is reviewing the customer funds protection provisions of the CEA and Commission regulations to identify possible improvements to the protection of customer funds. As part of this process, staff held a two-day public roundtable on February 29 and March 1, 2012, to solicit input on potential areas of regulatory reform and to identify possible enhancements to FCM internal controls surrounding the handling of customer funds. Panelists at the roundtable represented a broad and diverse cross-section of the futures industry, including academics, consumer groups, agricultural and energy interests, managed funds and pension plans, FCMs, derivatives clearing organizations, securities regulators, futures and securities SROs, and industry trade associations.

The roundtable provided a forum for Commission staff to obtain information and views on a range of issues. Day one of the roundtable focused on the advisability and practicality of implementing the legal segregation with operational commingling model as the segregation model for collateral posted by futures customers (the Commission has already approved this model for swaps); alternative models for the custody of customer collateral; FCM controls over the disbursement of customer funds deposited for trading on U.S. futures markets; increasing transparency surrounding an FCM's holding and investment of customer funds; and lessons learned from commodity brokerage bankruptcy proceedings. Day two of the roundtable focused primarily on the protection of customer funds deposited with FCMs for trading on foreign futures markets; particular issues associated with dually-registered BD-FCMs; and enhancing the self-regulatory structure.

Commission staff has also held discussions on enhancing customer protections with representatives of the Futures Industry Association (FIA) and the two primary futures market DSROs, the NFA and the CME. Staff is taking into consideration the recommendations that FIA issued in its document titled, "Initial Recommendations for Customer Funds Protection," and in its publication of frequently asked questions regarding the protection of customer funds. The CME and the NFA have also

implemented certain improvements in their capacity as DSROs and are considering others.

While Commission staff has not yet proposed amendments to Commission regulations, it is expected that staff will make recommendations in several areas, including rules requiring FCMs to establish certain internal controls and other requirements related to their handling of customer funds, rules requiring greater transparency and reporting regarding the investment and holding of customer funds, and amending the requirements governing Part 30 secured accounts.

Regulatory Coordination for Complex Global Financial Institutions

Many FCMs intermediate futures transactions for customers trading on both U.S. and foreign markets, and also provide services as securities BDs. The Commission and futures SROs have historically focused their resources and oversight efforts on such FCMs' futures activities, including the firms' compliance with minimum capital requirements and the requirements to segregate customer funds for trading on U.S. and non-U.S. futures markets.

The recent bankruptcies of Refco, Lehman Brothers, and MF Global highlight the challenges presented by large FCMs that operate with affiliated entities in multiple jurisdictions. Many of these entities have lines of business that are subject to multiple U.S. and non-U.S. regulatory authorities, which requires coordination among regulators to ensure effective and complete financial oversight.

Staff currently is reviewing and revising its oversight programs to better address the risks presented by large, complex financial institutions. Staff plans to focus greater attention on assessing such entities' liquidity and operational risks. Staff also plans to increase its review of such firms' internal controls over the handling of customer funds. Staff is also reviewing Commission regulations to assess whether to require firms to provide notice of, or seek approval for, new lines of business or operations prior to implementation. Furthermore, any efforts by regulators to effectively oversee the unwinding of a dually-regulated BD-FCM require significant coordination between futures regulators and securities regulators, including SROs. It is imperative that regulators coordinate their efforts and take steps to ensure that the actions taken by one regulator do not materially impact the ability of other regulators to effectively wind down the business of a firm and minimize the impact on the regulated financial markets.

SIPC Insurance

SIPC insurance provides financial assistance to securities customers in the event that a failed BD owes customers cash or securities that are missing from customer accounts. SIPC coverage is limited to $500,000 per customer, including up to $250,000 for cash.

The use of an insurance-type fund comparable to SIPC coverage has been debated in the futures industry for many years. Issues that have been identified include the significant costs of establishing and maintaining such a fund for commodity customers. Unlike the securities markets, which have a significant amount of retail participation, futures customers are predominantly institutional in nature. Such institutional customers often have substantial account balances with FCMs that would require significant insurance pay-outs in the event of an FCM failure. Commission staff is considering the feasibility of establishing insurance-type protection, however, or other comparable protections, for futures customers as it conducts a broader assessment of the enhancement of protections afforded customer funds.

Ongoing Investigations

Commission staff has cooperated with, and shared information with, the SIPA Trustee since MF Global filed for bankruptcy. One of the areas where Commission staff has shared information with the Trustee is the analysis of the movement of customer funds out of segregated accounts during the period prior to the bankruptcy filing to identify potential improper withdrawals or distributions. Staff continues to provide assistance to the Trustee in his efforts to recover customer funds, including funds held for customers trading on foreign markets.

The Commission's Division of Enforcement is also actively engaged in the investigation concerning the shortfall of customer funds. Staff is speaking with witnesses and reviewing documents and other information. They are proceeding as expeditiously as they can. As the Committee will understand, I cannot disclose any specific details of the investigation because they are nonpublic, and because I do not want to prejudice any potential enforcement action. In general, however, depending on the specific facts and circumstances, a shortfall in customer segregated funds could amount to a violation of the CEA and Commission regulations including those that: (1) govern segregated funds; (2) prevent theft of customer money; (3) require our registrants to properly supervise accounts; (4) prevent making false statements; and (5) prohibit deceptive schemes. Depending on the specific facts and circumstances, the Commission could file an enforcement action against corporate entities and/or individuals who have violated the CEA or regulations. In addition, depending on the specific facts and circumstances, individuals could also be liable if they are "control persons" of a company that violated the law. A "control person" generally refers to management. Depending on the specific facts and circumstances, an enforcement action could be filed against individuals who "aid and abet" violations by companies. Finally, Commission regulations impose obligations on accountants who audit FCMs and on the banks that hold customer segregated funds for FCMs. My mention of these particular provisions does not in any way limit the Division's investigation or the relief we can seek, nor does it indicate that the Division has reached any conclusions.

Generally, the Commission has the authority to, among other things, seek and impose civil monetary penalties, require a defendant to disgorge ill-gotten gains, obtain restitution for customers and obtain other injunctive relief. In terms of civil monetary

penalties, the Commission can seek the greater of three times the defendant's gain, or a set amount, which is currently $140,000 per violation. Civil monetary penalties are paid to the U.S. Treasury, while restitution is paid to victims who suffered losses.

The Commission is a civil enforcement agency, so we cannot seek imprisonment as a sanction in an enforcement action. However, a willful violation of the CEA, or our regulations, is a federal crime, which can be prosecuted by a United States Attorney. We do not have any say in whether or not the criminal authorities prosecute, and I understand that they have a higher burden of proof than we have.

Conclusion

I understand the severe hardship that MF Global's bankruptcy has caused for thousands of customers who have not yet been made whole. These customers may have 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. The shortfall in customer funds was a shock to the markets from which we have not yet recovered.

I believe the Commission can make improvements to our regulatory oversight of FCMs and DSROs to help restore confidence in the futures markets, and I will work with the Commission and Congress to implement the rules necessary to enhance our ability to protect market users and to foster open, competitive, and financially sound markets.