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THE COLLAPSE OF MF GLOBAL: LESSONS LEARNED AND POLICY IMPLICATIONS

HEARING

BEFORE THE

COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS UNITED STATES SENATE

ONE HUNDRED TWELFTH CONGRESS

SECOND SESSION

ON

EXAMINING THE LESSONS LEARNED FROM THE COLLAPSE OF MF GLOBAL

APRIL 24, 2012

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THE COLLAPSE OF MF GLOBAL: LESSONS LEARNED AND POLICY IMPLICATIONS

TUESDAY, APRIL 24, 2012

U.S. SENATE,
COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS,
Washington, DC.

The Committee met at 10:03 a.m., in room SD–538, Dirksen Senate Office Building, Hon. Tim Johnson, Chairman of the Committee, presiding.

OPENING STATEMENT OF CHAIRMAN TIM JOHNSON

Chairman JOHNSON. I will call this hearing to order.

Today's hearing will examine the lessons learned from the collapse of MF Global. The misuse of customer accounts by one of the world's largest commodities and derivatives brokers has shaken confidence in our markets and deserves a thoughtful discussion of how to better protect farmers, ranchers, and investors going forward.

But before we get to these important issues, I would like to express my deep concern that almost 6 months after MF Global's bankruptcy, thousands of former customers—including hundreds of South Dakotans—still have not recovered the $1.6 billion removed from what should have been protected customer accounts. I know that the trustees, regulators, as well as the FBI and Justice Department continue to investigate what happened in the final chaotic days of MF Global, but these customer funds must be returned without further delay to their rightful owners, and those individuals and executives responsible for transferring these funds must be held accountable to the full extent of the law. Last, it is not acceptable for MF Global executives to be given bonuses when customers have not recovered funds improperly taken from them by MF Global, and I thank Senator Tester for his leadership on this issue.

Since the collapse of MF Global in October 2011, my staff has worked closely with Senator Shelby's staff in conducting extensive interviews and due diligence with the regulators, self-regulatory organizations, and other parties involved in overseeing MF Global and its bankruptcy. We have also coordinated with the Senate Agriculture Committee—which has primary jurisdiction over matters involving commodities—in holding a series of bipartisan briefings for all Senate staff with representatives of many of the organizations before us today to help our constituents impacted by the firm's downfall.

As investigators seek to recover MF Global customer funds and hold accountable those responsible for any wrongdoing, this Committee will focus our attention on preventing future abuses and the other critical public policy issues raised by the collapse of MF Global.

Today's hearing provides a unique opportunity to ask an important set of questions: How can we strengthen protections for customer accounts at FCMs or broker-dealers, including those firms that hold U.S. customer funds abroad? Given the size of the shortfall in MF Global's customer accounts, what should Congress understand about the idea of extending to commodity accounts similar insurance protections that are currently available to securities accounts under the Securities Investor Protection Act? And how can we continue to improve regulatory oversight and coordination for large, complex global financial institutions?

MF Global may also provide some early lessons about the Wall Street Reform Act since it is the first collapse of a major financial institution since the law's passage. For example, the story of MF Global teaches us that effective customer protection and market oversight demands that we fully fund our regulatory cops on the beat. In hindsight, there is little doubt that the regulators responsible for monitoring MF Global should have taken additional steps. But shortchanging the CFTC or SEC of much needed funding will only force them to delegate even more authority to self-regulatory organizations in a way that could impair effective market surveillance. When funding cuts prevent regulators from inspecting firms or assigning necessary staff to monitor crises, the American people and market confidence pay the price.

Additionally, a key pillar of the Wall Street reform bill was to end too big to fail; and if MF Global demonstrates anything, it is that those who take risky bets that bring down their companies are now free to fail and will not receive any more taxpayer bailouts.

To preserve time for questions, opening statements will be limited to the Chair and Ranking Member. However, I would like to remind my colleagues that the record will be open for the next 7 days for additional statements and other materials.

I now turn to Ranking Member Shelby.

STATEMENT OF SENATOR RICHARD C. SHELBY

Senator SHELBY. Thank you, Mr. Chairman. Thank you for calling this very important hearing.

The collapse of MF Global is one of the largest bankruptcies in U.S. history and the greatest consumer protection failure since the enactment of the Dodd-Frank Act. It has been 6 months or more since MF Global filed for bankruptcy, and the ownership of $1.6 billion in customer assets remains in dispute. Hundreds of MF Global customers are still waiting to learn how much, if any, of their funds will be returned to them.

The disorderly failure of MF Global occurred despite the fact that it was regulated by not only the CFTC and the SEC, but also the Financial Industry Regulatory Association, the Chicago Board Options Exchange, the National Futures Association, and the Chicago Mercantile Exchange. The job of each of these regulators was to ensure that customer assets were protected.

That $1.6 billion in customer assets that remain subject to ownership dispute reveals a serious regulatory failure, I believe. Accordingly, the purpose of today's hearing should be to help the Committee determine which regulators failed to do their job and why.

To assist this effort, I asked the CFTC's Inspector General last November to examine the Commission's oversight and regulation of MF Global. The Inspector General's findings, along with other ongoing investigations, should assist Congress in its efforts to hold regulators accountable for any identified failures.

I also asked the CFTC's Inspector General to determine whether Chairman Gensler's recusal was appropriate and whether he should have recused himself much earlier in the process.

Prior to MF Global's bankruptcy, Chairman Gensler had multiple contacts with MF Global and its CEO, Jon Corzine, concerning the CFTC's regulation of the firm. If a recusal was appropriate, it seems it would have been more appropriate to start at Mr. Corzine's tenure at MF Global rather than after the firm had failed.

Furthermore, this Committee's due diligence has revealed that Chairman Gensler played an active role in the oversight of MF Global during the week leading up to its failure. Yet Chairman Gensler's recusal now shields him from explaining his actions. I believe this is unacceptable. Chairman Gensler owes the public a full accounting of his role in the fall of MF Global. It appears by his absence today, however, that we will have to wait a little bit longer for such an accounting.

MF Global certainly will not be the last financial firm to fail. Failure is an inevitable part of the free market system. But our goal should be not to protect the private market from failure. Our goal, I believe, should be to establish a credible regulatory system that protects consumers while leaving the market free to innovate and to expand. We must then hold that regulatory system accountable for its failures. This is exceedingly difficult, however, when one of the main participants refuses to speak here.

I look forward to the testimony today, and I thank our witnesses for appearing. Perhaps 1 day, Mr. Chairman, we will hear from Mr. Gensler. Today does not appear to be that day, however.

Thank you.

Chairman JOHNSON. Thank you, Senator Shelby.

Now I will briefly introduce our witnesses.

Mr. James W. Giddens is the trustee for the Securities Investor Protection Act Liquidation of MF Global Incorporated.

The Honorable Louis J. Freeh is a trustee of MF Global Holdings.

The Honorable Jill Sommers is a Commissioner for the U.S. Commodity Futures Trading Commission.

Mr. Robert Cook is the Director of the Division of Trading and Markets for the U.S. Securities and Exchange Commission.

Mr. Richard Ketchum is the chairman and CEO of the Financial Industry Regulatory Authority.

Mr. Terrence A. Duffy is executive chairman of the Chicago Mercantile Exchange.

I thank all of you again for being here today. I would like to ask the witnesses to please keep your remarks to 5 minutes. Your full written statements will be included in the hearing record.

Mr. Giddens, you may begin your testimony.

STATEMENT OF JAMES W. GIDDENS, TRUSTEE, SECURITIES INVESTOR PROTECTION ACT LIQUIDATION OF MF GLOBAL INC.

Mr. GIDDENS. Chairman Johnson, Ranking Member Shelby, and Members of the Committee, thank you for inviting me to testify. I take seriously my duty as the trustee of MF Global Inc. to treat commodities and securities customers and general creditors equitably. I would like to provide some proposals that may merit further study and, of course, input from regulators, industry experts, and the public.

A lack of supervision and inattention to maintaining segregation of customer accounts caused the shortfall of customer funds. Thus, a possible remedy is imposing personal liability on senior officers and directors when there is a regulatory shortfall.

Consideration should also be given to requiring not only financial operating principles but senior officers, including the CEO and the CFO, to certify compliance with commodity segregation requirements on a much more frequent basis.

Second, I suggest the establishment of a commodities customer protection fund. We found that more than three-quarters of the commodities customers had accounts of a value of less than $100,000 each. Thus, a fund providing for protection of up to a maximum of $100,000 would have made a substantial number of the claimants whole within days of the bankruptcy filing.

Third, we have learned that many commodities customers have not fully understood the nature and risk of certain financial products in which their funds were invested. Currently, commodities customers are not subject to suitability requirements as are securities customers. In my view they should be.

As a fourth suggestion, futures commission merchants might be required to segregate an amount in excess of 100 percent of customer funds. That would help ensure that there is a sufficient cushion at all times for commodities customers.

Let me now turn to funds held for U.S. customers trading on foreign exchanges. Under current rules, FCMs are not required to calculate the segregation requirements for foreign trading in the same way as they do for domestic trading. Reliance on this alternative calculation resulted in a substantial difference in funds segregated. The alternative calculation, had it been in place, would have required a greater segregation. The alternative calculable should be eliminated.

Finally, I believe there is a great need for international cooperation on insolvency laws. Customers would benefit from greater harmonization of the rules governing the segregation of customer funds for both commodities and securities customers. I have been engaged in active discussions since November with the administrators of MF Global U.K. Ltd. concerning the return of approximately $700 million commodities customers' property. This dispute is now being submitted to the U.K. courts for resolution.

In concluding, my staff and I continue to work as quickly as possible to return assets to all claimants. We have distributed in excess of $4 billion. We have sought court approval to distribute an additional $685 million to commodities claimants.

Thank you, Chairman Johnson, Ranking Member Shelby, and other Members of the Committee for this opportunity to testify before you.

Chairman JOHNSON. Thank you.

Judge Freeh, please proceed.

STATEMENT OF LOUIS J. FREEH, TRUSTEE, MF GLOBAL HOLDINGS LTD.

Mr. FREEH. Thank you very much. Good morning, Chairman Johnson and Senator Shelby and your colleagues. Thank you for the opportunity to appear here.

You have my opening statement. I just want to highlight a few things for you and leave sufficient time, obviously, for your questions and my colleagues on the panel.

I was appointed as the Chapter 11 trustee effective November 28th of last year. There are, in addition to MF Global Holdings, five other subsidiaries to which I am acting as the Chapter 11 trustee.

I think everyone understands the functions of the Chapter 11 trustee very distinct and very different from my colleague Mr. Giddens. Under the Bankruptcy Code, my obligation is to investigate the acts, conduct, look at assets, liabilities, and the financial condition of the debtors, among other things.

Unlike Mr. Giddens, who is charged primarily with the return of customers' investment property, the responsibility of the Chapter 11 trustee is to maximize the value of the estate for the creditors, and we have a list of many creditors, including the top 20, which is, I believe, in the materials.

When I was appointed in November, I landed in the middle of a number of issues: first, very ongoing, active investigations by the agencies represented here this morning; in addition to two Federal prosecutors' offices, as well as the SIPA trustee.

One of my first challenges was to understand what documents the Chapter 11 trustee and the estates controlled so I could make some arrangements and ensure that the investigators could access the information they needed without compromising any of the privileges that I have a fiduciary responsibility to protect.

So we looked at thousands of materials. My team and I, which consists of lawyers, financial experts, and investigators, determined what the materials were over which we had authority and jurisdiction. We reviewed thousands of pages, and we then set in place a process that would quickly produce the documents to the investigators. We did a limited waiver of the existing privileges that may appertain to the Chapter 11 trustee, and I was happy to say that ultimately all those issues were resolved, and the process of producing evidence to the investigators has gone forward expeditiously.

We are very sensitive, of course, to the fact that many customers have lost huge amounts of money and collateral that was entrusted to, in this case, the subsidiary MF Global Inc. We have scrubbed

our own cash collateral upon direction by the bankruptcy judge to make sure that none of the cash collateral in the estate is in any way related to or would be part of the customer accounts. And we concluded, with no disagreement from Mr. Giddens and his staff, that the cash collateral that the estates now possess does not include misappropriated or misdirected customer funds.

Let me also talk and I am pleased to be able to talk about the subject of bonuses. This was raised very appropriately, Senator Tester, by you and your colleagues. The source of this was, as you know, a media report, and I do not have control over what is in the media, no more than anybody in this room does. But I want to make it very clear it was never my intention to pay any bonuses. I never had a plan in place to pay any bonuses to senior executives. I read the story with a lot of surprise. There had been no discussions between myself and my staff about bonuses to senior executives. And bonuses are not part of my consideration now, and they have not been in the past. So I want to be as clear as I can about that.

My responsibility as trustee is to maintain the people that I need right now to help administer a cost-efficient and well-administered estate. So there are 15 employees. These are noninsider employees who worry about tax, who worry about financing, unwinding transactions. They are all working at this point on salaries. The three senior executives who have been, I believe, before the Senate are working also on salaries.

If I have to negotiate with any of the employees, the noninsiders, the 15 employees, to stay onboard because there is a $22 million tax refund that I need to get for the estate, they have the expertise and the experience, you know, I will set fair and competitive salaries with them. If they do not agree with that, then that is not going to work out.

I want to remain transparent, as I must in this bankruptcy process. Everything I do is subject to review not just by the trustee but the bankruptcy court. All of our fees, all of our expenses have to be reviewed there. So I want to conduct the Chapter 11 debtor estates with full transparency and cooperation.

In closing, I just want to say I have worked very cooperatively with Mr. Giddens. Our staffs are in sometimes daily contact. We meet on a regular basis. There will be times when our interests diverge, just as the interests of other parties in this very complex and, I think, long-running bankruptcy will occur. But we have some very clear and immediate common goals, which is to get as many assets back to the estates as possible. And then ultimately courts in England, perhaps the bankruptcy court in New York will ultimately make decisions about how those assets are distributed. But sharing the information, getting the assets, returning them is a very common critical need.

From the perspective of the SIPA trustee, I very much endorse the six very important considerations that he sets forth, particularly on the international cooperation. We have a lot of assets, we believe, that are in the U.K., but the U.K. has a separate administrator. There is a separate court system. We do not have privity as the holdings company to challenge and file some of the claims and the subsidiary Inc. will do. But it is a very difficult task to get facts

and retrieve assets overseas, so some restrictions about how segregation should be mandated for U.S. investors overseas I think is a key one from the point of view of the Chapter 11 trustee, and I would just emphasize that.

Thank you very much.

Chairman JOHNSON. Thank you.

Commissioner Sommers, please proceed.

STATEMENT OF JILL E. SOMMERS, COMMISSIONER, COMMODITY FUTURES TRADING COMMISSION

Ms. SOMMERS. 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.

On November 9th of 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 the shortfalls in the customer accounts. While I am happy to be here today to testify, the scope of my election as Senior Commissioner for MF Global Matters does not extent to the market-wide policy implications arising from MF Global's failure. Chairman Gensler remains in charge of directing Commission staff to develop recommendations for enhancing Commission and designated self-regulatory organization programs that are related to the protection of customer funds and has instructed staff to do so.

My focus has been on making sure that the Commission is doing everything it can to facilitate the recovery of customer funds and to bring those responsible for any violations of the Commodity Exchange Act or Commission regulations to justice.

Towards those ends, over the past 5½ months Commission staff 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.

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. 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 lost or frozen.

Section 4d of the CEA and Commission regulations require that an FCM holding customer funds treat such funds as belonging to the customer at all times. FCMs are prohibited from using a customer's funds to margin or guarantee the trades or contracts of another customer or of the FCM. And the FCM must maintain sufficient funds in segregated accounts to cover the net liquidating equity of each of its customers at any given point in time.

Our regulations also require an FCM to hold customer funds deposited for trading futures and options listed on foreign boards of trade in separate accounts known as "Part 30 secured accounts."

The Part 30 rules provide for an alternative calculation of the amount of funds required to be segregated that does not afford the same protections as the net liquidating equity calculation that is used for Section 4d funds. This is something that I think should be changed.

The Act and the Commission regulations establish a regulatory structure where frontline financial regulation is performed by designated self-regulatory organizations. The Chicago Mercantile Exchange and the National Futures Association are the two primary futures market DSROs. FCMs are subject to CFTC-approved minimum financial and reporting requirements that are enforced in the first instance by the DSROs. Many FCMs are also registered with the SEC as broker-dealers. These duly registered broker-dealer FCMs are subject to the jurisdiction of both the CFTC and the SEC.

To ensure that all activities of a broker-dealer/FCM are properly reviewed, futures and securities regulators, including SROs, coordinate their regulatory oversight. This coordination includes periodic meetings of the Inter-Market Financial Surveillance Group.

MF Global was duly 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 markets activities and had primary responsibility for overseeing the FCM's compliance with capital, segregation, and financial reporting obligations required by the CFTC.

Prior to the bankruptcy, the futures and securities regulators shared information and examination results regarding MF Global. In August of 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 broker-dealer to take on with regard to certain repo-to-maturity transactions on foreign sovereign debt. At approximately the same time, the SEC staff contacted CFTC staff to inform us of the capital charges. The CFTC staff also consulted with CME, FINRA, and CBOE regarding the imposition and rationale for these additional capital charges.

Commission staff consulted with domestic and foreign regulators during the period of October 24th through October 31st, as well as in the critical hours leading up to the bankruptcy filing. At the direction of Chairman Gensler, commission staff continues to review customer fund protection provisions of the Commodity Exchange Act and our Commission regulations to identify possible improvements.

While the staff has not yet proposed amendments to the Commission, it is expected that they will make recommendations in several areas. At a minimum, I believe that changes should be made to our Part 30 rules so that customer funds held for trading on foreign markets are subject to the same net liquidating equity calculations as Section 4d funds, that more information be provided to customers regarding how their funds are held and invested, and that more frequent reporting be provided to regulators and that FCMs' internal controls for the handling of customer funds be strengthened.

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 they never anticipated that their segregated accounts were at risk of suffering losses that were not associated with their trading. The shortfall in customer funds was a shock to the market 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 help 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.

Thank you.

Chairman JOHNSON. Thank you.

Mr. Cook, please proceed.

STATEMENT OF ROBERT COOK, DIRECTOR, DIVISION OF TRADING AND MARKETS, SECURITIES AND EXCHANGE COMMISSION

Mr. COOK. Chairman Johnson, Ranking Member Shelby, and Members of the Committee, good morning. My name is Robert Cook, and I am the Director of the Division of Trading and Markets at the Securities and Exchange Commission. Thank you for the opportunity to testify on behalf of the Commission concerning the lessons learned and policy implications of the collapse of MF Global.

The bankruptcy of MF Global has resulted in serious hardship for many of its customers, who have experienced significant delays and uncertainty with respect to their ability to access their own assets. More broadly, the failure of MF Global and the shortfall in customer assets highlight the need for financial firms and for regulators to remain vigilant in ensuring that customer assets are appropriately protected.

SEC rules are designed to protect customer property by prohibiting broker-dealers from using customer funds and securities to support their proprietary positions or expenses. Broker-dealers that hold securities or cash for customers must maintain physical possession or control over securities that customers have paid for in full and cannot use these securities to support the firm's own business activities. Further, when broker-dealers extend credit to allow customers to buy securities on margin, the rules strictly limit how much of those securities the broker-dealer can pledge to finance the credit it has extended to customers.

The rules also protect cash held for customers or derived from customer securities by requiring the broker-dealer to maintain a reserve in a bank account for the exclusive benefit of customers in an amount that exceeds the net amounts owed to customers. These funds cannot be invested in any instrument that is not guaranteed by the full faith and credit of the U.S. Government.

Together with applicable SEC capital requirements and protections under the Securities Investor Protection Act, this regime is designed to ensure that if a broker-dealer fails, customer securities and funds will be available to be returned to those customers. The preferred method of returning securities customer assets in a SIPA liquidation is to transfer those assets to another broker-dealer. On

December 9th, the bankruptcy court approved the initial sale and transfer of substantially all securities custody accounts to a solvent broker-dealer. This sale and transfer applied to approximately 318 accounts held for nonaffiliated securities customers. The trustee has reported that since the transfer, nearly all former MF Global securities customers have received 60 percent or more of their account value; 194 customers have received the entirety of their account balances. We understand that those 194 customers include anyone entitled to SIPA protection with a net equity claim of up to $1.25 million.

Generally, the rules governing protection of customer funds and securities have worked reasonably well over time, but we are considering whether there are ways that they can be strengthened. For example, the SEC has proposed to clarify and strengthen the rules governing audits of broker-dealers, including an auditor's examination of the effectiveness of broker-dealer controls relating to the custody of customer assets. The SEC also continues to work with the self-regulatory organizations, or SROs, to strengthen broker-dealer financial responsibility requirements.

For example, in June of last year, the SEC approved a FINRA rule requiring the establishment of registration, qualification, examination, and continuing education requirements for certain operations—or "back office"—personnel, including those who handle customer assets. This rule should help ensure that those responsible for these operations are fully versed in their legal obligations, including those relating to the segregation and protection of customer assets.

In February of this year, a modernization task force formed by SIPC issued 15 recommendations to the SIPC Board, including proposed statutory changes. The SEC staff is evaluating these recommendations as well, several of which are directed to the scope and dollar limit of protection for individual customers in a SIPC liquidation.

The SEC is also engaged in a number of efforts, both domestic and international, to share more and better data and qualitative assessments of firms and markets and to do so in a timely way. Some of these efforts involve improved coordination with the SROs, including establishing more frequent meetings with certain SROs with financial oversight responsibilities.

Thank you again for the opportunity to testify on this important subject, and I look forward to answering any questions you may have.

Chairman JOHNSON. Thank you.

Mr. Ketchum, please proceed.

STATEMENT OF RICHARD G. KETCHUM, CHAIRMAN AND CHIEF EXECUTIVE OFFICER, FINANCIAL INDUSTRY REGULATORY AUTHORITY

Mr. KETCHUM. Chairman Johnson, Ranking Member Shelby, and Members of the Committee, thank you for the opportunity to testify today. My name is Richard Ketchum, Chairman and CEO of the Financial Industry Regulatory Authority, or FINRA.

When a firm like MF Global fails, there is always value in reviewing the events leading to that failure and examining where

rules and processes might be improved. Clearly the continued impact of MF Global's failure on customers who cannot access their funds is of great concern, and every possible step should be taken to restore those accounts as quickly as possible.

With respect to oversight of MF Global's financial and operational compliance, FINRA shared oversight responsibilities with the SEC, of course, and the Chicago Board Options Exchange, which was the designated examining authority, or DEA, for MF Global. When FINRA is not the DEA for one of its regulated broker-dealers, we work closely with the DEA and routinely analyze the firm's FOCUS report filings and annual audited financial statements as part of our ongoing oversight of the firm.

While that monitoring focuses on a broad range of issues, it is particularly relevant to note that our financial surveillance team placed a heightened focus on exposure to European sovereign debt, and during April and May of 2010, we began surveying firms as to their positions in those instruments.

In a review of MF Global's audited financial statements filed with FINRA on May 31 of last year, our staff raised questions about a footnote disclosure regarding the firm's repo-to-maturity, or RTM, portfolio. During discussions with the firm, FINRA learned that a significant portion of that portfolio was collateralized by approximately $7.6 billion in European sovereign debt. According to U.S. GAAP, RTMs are afforded sale treatment and, therefore, not recognized on the balance sheet. Notwithstanding that accounting position, the firm remained subject to credit risk throughout the life of the repo.

Beginning in mid-June, FINRA, along with the CBOE, had discussions with the firm regarding the proper treatment of the RTM portfolio. Our view was that while recording the repos as sales was consistent with GAAP, they should not be treated as such for purposes of the capital rule given the market and credit risk those positions carried. As such, we asserted that capital needed to be reserved against that position.

FINRA and the CBOE also had discussions with the SEC about our concerns. The SEC agreed with our assertion that the firm should be holding capital against these positions. The firm fought this interpretation throughout the summer, appealing directly to the SEC, before eventually conceding in late August.

MF Global infused additional capital and made regulatory filings on August 31st and September 1st that notified regulators of the identified capital deficiency and the change in net capital treatment of the RTM portfolio.

Following this, FINRA added MF Global to alert reporting, a heightened monitoring process whereby we require firms to provide weekly information, including net capital and reserve formula computations.

During the week of October 24th, as MF Global's equity price declined and its credit rating was cut, FINRA increased the level of surveillance over the firm. At the end of that week, FINRA was onsite at the firm, with the SEC, as it became clear that MF Global was unlikely to continue to be a viable stand-alone business. Our primary goal was to gain an understanding of the custodial locations for customer securities and to work closely with potential

acquirers in hopes of avoiding SIPC liquidation. As has been widely reported, the discrepancy discovered in the segregated funds on the futures side of the firm ended those discussions.

While FINRA believes that the financial securities rules of the SEC combined with SIPC create a good structure for protecting customer funds, firm failures provide an important opportunity for review and analysis of where improvements may be warranted.

FINRA has identified changes that can be made to better protect customers and their funds through both our own rulemaking process and also in terms of our coordination with our regulatory counterparts.

Most recently, FINRA and the Chicago Mercantile Exchange established regular coordination calls so that our respective staffs can share information about the approximately 50 firms that are both broker-dealers and FCMs. In addition, we have initiated a series of briefings on select firms for domestic and international regulators of securities and futures. Our next briefing will be in June, and we have expanded the list of the regulators and SROs included in the event.

We have also continued our work on rulemaking efforts aimed at enhancing financial surveillance. Starting in October, FINRA-regulated firms must file additional financial and operational reports that capture more granular detail about a firm's revenues and expenses. And last week, FINRA's board approved an additional report that would inform the assessment of off-balance-sheet activities on firms' net capital, leverage, and liquidity.

FINRA shares your commitment to reviewing MF Global's collapse. We will continue to review our own rules and procedures and reach out to our fellow regulators to identify areas where current processes may be enhanced.

Again, thank you for the opportunity to share our views. I would be happy to answer any questions you may have.

Chairman JOHNSON. Thank you.

Mr. Duffy, please proceed.

STATEMENT OF TERRENCE A. DUFFY, EXECUTIVE CHAIRMAN, CME GROUP INC.

Mr. DUFFY. Chairman Johnson, Members of the Committee, thank you for the opportunity to testify respecting lessons learned from the collapse of MF Global. I have previously testified respecting MF Global's misuse of segregated customer funds and CME's efforts on behalf of customers. Today I will summarize our efforts in the industry's to restore customer confidence.

The shortfall in customer segregated funds was limited to the funds under MF Global's control. The customers' funds held in segregation by CME's clearinghouse to cover futures positions were complete. Our ability to transfer the positions and the collateral of our customers was undone by a provision in the Bankruptcy Code requiring *pro rata* loss sharing among all customers. We believe that Congress can help protect customers whose collateral is safeguarded at a clearinghouse. It can do that by changing the Bankruptcy Code to permit clearinghouses to transfer fully collateralized customers to other clearing members despite a failure of their clearing member.

The industry is united in its search for solutions that will restore confidence in regulated futures and derivatives markets. Obviously, changes in the Bankruptcy Code are not easy or quick, and it is constructive to look at a wide range of actions that can be implemented without legislation.

CME Group, along with other exchanges and the National Futures Association, has proposed four forms of intensified reporting to prevent misuse of customer funds. The Futures Industry Association, on behalf of its members, also proposed enhanced reporting and greater transparency. CME Group is already implementing proposals which will include:

One, mandatory daily reporting of segregation statements by all FCMs;

Two, additional surprise reviews of customers' segregated accounts;

Three, a requirement that the FCM's CEO or CFO sign all payouts of customer segregated funds exceeding 25 percent of excess segregated fund amounts, plus immediate notification to CME;

And, four, a bimonthly report reflecting how segregated funds are invested and where they are held.

CME has also challenged the industry and the Commission to consider whether other solutions will better serve the interests of customers and the industry. In addition to the proposed amendment of the Bankruptcy Code, CME is working with its clearing members to find a structure that will protect their collateral against fellow customer and fraud risks. We are committed to finding a solution that will provide strong protection for the segregated funds of futures and swap customers from a legal, operational, and cost/benefit perspective without destroying the industry's business model.

In addition to these regulatory initiatives, we also recently launched the CME Group Family Farmer and Rancher Protection Fund. This fund is designed to protect family farmers, family ranchers, and their cooperatives in the event of shortfalls in segregated funds. We hope these steps will give additional confidence to U.S. futures markets after the actions and failure of MF Global. The misconduct of MF Global, however, should not serve as a reason to undermine the current system of frontline auditing and regulating by clearinghouses and exchanges.

Some critics suggest that the current regulatory system is compromised by conflicts of interest. There are no conflicts of interest in CME's duties to the CFTC, to its customers, and its shareholders. CME's duty to its shareholders requires that it diligently keep its markets fair and open by vigorously regulating all market participants.

Federal law mandates an organizational structure that eliminates conflicts of interest. The current regulatory model has served the futures industry, its customers, and the public very well. We look forward to working with the Congress and the regulators to enhance customer protections and foster confidence in our markets.

I thank you for your time this afternoon.

Chairman JOHNSON. Thank you. I would like to thank all of our witnesses for their testimony. As we begin questions, I will ask the clerk to put 5 minutes on the clock for each Member.

Judge Freeh, just to be clear, given that $1.6 billion of customer funds have yet to be recovered due to mismanagement or possible illegal transfers by MF Global, can you commit to us today that your office will not be seeking bonuses for any former or current MF Global employee?

Mr. FREEH. Yes, Senator.

Chairman JOHNSON. Mr. Giddens, if some type of SIPC-like insurance coverage had been in place for commodities accounts, how would that have impacted the transfer of client positions to other FCMs as well as the claims distribution process for former customers of MF Global? Do you believe that Congress should study and revisit the idea of extending to commodities accounts an insurance coverage similar to that provided for securities accounts under the securities Investor Protection Act?

Mr. GIDDENS. Senator, yes. SIPC proceedings, which govern the liquidation of broker-dealers, contain essential and well-established procedures for contemplating and facilitating transfers of accounts to other solvent broker-dealers and provide mechanisms for the prompt payment of customer claims. All of this is greatly facilitated because there is the financial support of the SIPA fund, which has in the case of SIPA several billion dollars of assets and the ability to assess the industry for additional funds.

Those funds would assist if it were necessary to cover shortfalls to enable a trustee to transfer accounts to other solvent—by analogy, to other solvent FCMs. I think as Mr. Duffy was alluding to, there are problems here because under the statute you have to distribute equally on a *pro rata* basis.

So, yes, I believe that if you had a fund which would give you more flexibility as a trustee, you could more rapidly transfer accounts and at least have that available in your arsenal of things to move things along.

Chairman JOHNSON. Commissioner Sommers, could you describe any legal actions or other efforts the CFTC is taking to recover the more than $700 million of U.S. customer funds being held in the U.K.? How has the work of the CFTC in this area been coordinated with Mr. Giddens' efforts to protect U.S. customers subject to CFTC Regulation 30.7?

Ms. SOMMERS. Thank you, Senator. The CFTC does not have the authority to bring an action in the U.K. court proceeding, but we are, as we are in the United States, working very closely with Mr. Giddens and his staff, the law firm that he has hired to represent the bankruptcy in the U.K. in front of the English court, and we will continue to monitor all of the different actions that happen in that proceeding.

Chairman JOHNSON. Mr. Giddens, do you have anything to add?

Mr. GIDDENS. Just to confirm that we do confer frequently with the CFTC about the strategy in the U.K. and the nature of the legal issues. Equally, we have, to the extent we can, shared information with Judge Freeh regarding that proceeding. Our view, of course, is that all of those funds in the U.K. are segregated assets that belong to the 30.7 customers of the broker-dealer.

Chairman JOHNSON. Mr. Duffy, do you have any views on the FIA recommendations offered last month to better protect segregated customer accounts? Also, would it be valuable for SROs

and the CFTC to receive daily electronic backup documentation on these accounts directly from exchanges, clearinghouses, and custodial banks in order to confirm that the self-reporting of seg funds by FCMs is accurate?

Mr. DUFFY. Let me take the latter first. As far as the daily reporting from the SRO and the CFTC to the exchanges, I am a big believer, Senator, in transparency and real-time reporting, so it is kind of hard to argue with that. The reality is what are the practicalities of getting that done. Even if we were to have it on a real-time basis, if people were having multiple books or doing nefarious activities, it would still be very difficult to detect what happened in the MF Global situation. So as much as I support real-time tie-outs, I think there is a lot of information that still needs to go into that.

As far as the FIA's recommendations on the signoffs and some of the things that they have proposed, yes, the CME Group is very supportive of their recommendations.

Chairman JOHNSON. I note that Senator Shelby has temporarily left the Committee hearing to attend an Appropriations hearing, and he will be back. Senator Corker.

Senator CORKER. Thank you, Mr. Chairman, and I thank all of you for your testimony.

I sit through most of these hearings, and today it almost gives you a headache to think about all the various regulators involved in one entity, and we created that, you all did, and so I am not criticizing that. But it does seem like there are a lot of silos and various areas that each of you look at that do not overlap properly. And what I would like to do is ask Mr. Giddens and Judge Freeh: What happened? What happened to the customer accounts? How did the money end up in places that it was not supposed to end up? We have talked about everything but that here today.

Mr. GIDDENS. Our analysis of what happened and where the money went I think is substantially concluded. That is the first phase of the process. Because of the liquidity crisis in the last week, something like $105 billion in cash went out of the firm to banks, depositories, some to commodities customers, some to securities customers in what on the surface appear to be ordinary commercial transactions. A great deal of this was caused by customers leaving the firm and asking that their assets be transferred out of the firm. Also, the firm had to scurry around to find additional collateral. Additional collateral was required with respect to the repo-to-market transactions which went from something like $200 million to maybe $900 million additional collateral required.

In these firms, cash is moved around from various accounts on a daily basis, and it is possible that if mistakes are made and you say we have excess in one category, we can use that category to move it to another, and with so much happening in the last week and so many volumes of transactions, that is where we think the—what accounts for the mistakes.

So we can trace where the cash and securities in the firm went, and that we have done. The second more complex phase, which we are also aggressively pursuing, is to get as much of that back if we have an appropriate legal theory to do that, and we have done that.

We have had some success to date, and we will continue to pursue that with a goal of getting back as much of the property as we can.

Senator CORKER. Let me ask you this question. We kind of all get the picture of what happened. A lot of money was moving around quickly. The firm was in a desperate state. With all of that occurring, regardless of, you know, the umpteen million regulators that look at this, the fact is—how do you keep that from—how do you keep at the end money going out of a customer account inappropriately to some other place? I mean, how can even a regulator at that instant keep that from happening?

Mr. GIDDENS. Given the fact that so-called operational personnel can move funds and have authority to do it, it is almost not possible to build a foolproof system which would—the checks that you have or the reporting requirements and also the totaling up on a daily basis of what the segregation requirements should be, if there are substantial mistakes in that, it permits someone to say theoretically I have an excess in the commodities funds; therefore, I can transfer that to the securities accounts, or vice versa.

We had an example shortly—after I was appointed, I had a call from MF Global itself saying we have wrongly transferred $220 million from the securities accounts to the commodities accounts, and we would like to reverse that. How that was done or who authorized it or whatever, you know, we cannot say. But, clearly, there were mistakes being made, and part of this—as I say, the process is that most people do not realize that relatively low-level operational people in any given time have the authority to transfer hundreds of millions of dollars——

Senator CORKER. Was there an investment committee? Is there personal recourse to the executives when these kinds of things happen? Is there a way to deal with them on a personal basis against their personal assets? And, second, was there any kind of investment committee or internal controls that existed there to keep this kind of thing from happening within the firm? And if not, are there other firms, to your knowledge, that have these same problems?

Mr. GIDDENS. On the personal liability, I think there are—my own personal view and the view of people working with me is that there are discrepancies so that seniors and higher-ups who do not directly authorize the young vice president to move money are probably—it is very difficult to suggest that they are personally liable. And that is one of the reasons I suggested that we look at that and begin to consider saying it is not enough when you are managing the firm, determining the investments and the overall strategy, if you in effect create the liquidity crisis, that you will bear some responsibility if there are shortfalls in customer property. I think it is certainly——

Senator CORKER. I know I am running out of time. Were there internal controls or an investment committee? Was there any discipline within the firm that kept one person from making a big bet and the company going haywire?

Mr. GIDDENS. My understanding was there was an investment committee. There were risk officers at the firm. There were examples of where recommendations were not taken by the risk officer, and under perfectly legitimate corporate structures, senior officers could choose to ignore that.

Our view of MF Global from our analysis of its operations was that the firm was poorly capitalized and had liquidity crises, highly leveraged before Mr. Corzine came to the firm, and, in fact, those problems continued. They certainly went through the motions of having operational supervision and risk supervision and the like. How effective that was I think is demonstrated by the ultimate failure of the firm.

Senator CORKER. Mr. Chairman, thank you for the time.

Chairman JOHNSON. Senator Menendez.

Senator MENENDEZ. Thank you, Mr. Chairman. Thank you all for your testimony.

Mr. Giddens and Mr. Freeh, let me ask you, I just heard your response to Senator Corker's last question that MF Global was poorly capitalized and had a liquidity crisis, that it was highly leveraged. Was that in essence the harbinger of its doom?

Mr. GIDDENS. That was certainly a large contributing factor, so that if they had a crisis, there was not much of a cushion to fall back on. I think also it would be the nature of their investments in risky European sovereign debt of countries such as, I believe, Italy, Spain, and Ireland, with the result that since those were purchased on margin, the margin amounts and the collateral put up had to be continually increased. So that toward the end, as I recall, something in the neighborhood of $200 to $300 million in margin became closer to $900 million in margin that had to be put up. So all of that created much more severe strains on the firm.

Mr. FREEH. Senator, also, in addition to that, a critical factor was really the inability of its IT and technology system to just keep pace with the trades and to even record them. In the last few days, there are many nonrecorded trades. Even now, to reconstruct what happened there is very difficult. The IT system and the technology, you know, was not equipped for the frenetic pace of trading in the last several days, and that combined with the miscalculation using the most generous term at this point, subject to investigation, of what was segregated and what was not segregated, and the inability to control and track the trades in the accounts was just a perfect storm for the disaster that occurred.

Senator MENENDEZ. So you clearly had between poor capitalization, liquidity crisis, highly leveraged, and inferior technology, a structural problem at MF Global.

Let me ask you this: Has it been part of your effort and review to determine what individuals at what level—I am trying to think here of structure more than individuals, but what individuals created the set of decisions that created the challenge that we have?

Mr. FREEH. Yes, Senator. That is a subject both of my investigation and Mr. Giddens. We are looking to determine the available causes of action, including fraud, lack of fiduciary responsibility.

Senator MENENDEZ. And where are you in that investigation at this point?

Mr. FREEH. We are just beginning it, sir.

Senator MENENDEZ. Just beginning it. So you cannot identify at this point the responsible parties?

Mr. FREEH. I could not do that fairly at this point.

Senator MENENDEZ. Let me ask you this, Mr. Giddens. You suggested in response, I think, in earlier testimony that director liabil-

ity might be a preventative measure. Isn't there director liability here now?

Mr. GIDDENS. There well may be, and we are looking at that. If there were breaches of fiduciary duty that are actionable, we will pursue them.

Senator MENENDEZ. Ms. Sommers, on December 11th, the CFTC finalized a rule prohibiting the investor of customer funds in foreign sovereign debt securities. If the rule had been finalized before the collapse of MF Global or not overturned in 2005, does the CFTC believe that MF Global would have avoided collapse?

Ms. SOMMERS. No, sir.

Senator MENENDEZ. OK.

Ms. SOMMERS. The investments under 1.25 are the permissible investments that the FCM can use to invest customer funds that are in segregation, but they cannot be used by the FCM themselves to invest it for the FCM's own gain.

Senator MENENDEZ. What is the likelihood of—my understanding is you have identified where the money is. What is the likelihood of recovering it on behalf of all of those individuals whose money is abroad?

Mr. GIDDENS. With respect to the $700 million that was represented to the U.S. customers as being segregated for them, our position is that under U.K. law, that money should be treated as segregated customer funds. And I think we are reasonably confident of a positive outcome from the U.K. courts, but there is no guarantee of that.

Senator MENENDEZ. One final question. Mr. Duffy, clearly what a company does in the first instance is the challenge. We would expect them to do the right thing, both legally and substantively and ethically. But in the absence of that, is there anything in this experience that says to you, heading CME, that there is something structural that needs to be changed to be able to at least mitigate the extent? My understanding is that there was a $700 million—some-odd instance in which they would have—reporting would have indicated that funds were commingled. That could not be stopped because it already was done. But might it have mitigated going to $1.6 billion.

Mr. DUFFY. Again, the number of $1.6 billion, you would have to ask Mr. Giddens where that came from. Our number is significantly lower, and we are referring to the U.S. number around $700 million as missing. And anything that we could have gained by the experience, I think that we have done everything as a DSRO. We have reviewed all of our practices going back looking through the whole forensic analysis of MF Global, and we feel very strongly that we did all the things that were appropriate.

I think Mr. Giddens said something that was very important just a moment ago. He said that the company has a liquidity crisis, and their increases went from $200 to $900 million on their margin calls. That money had to come from somewhere, and if there was a liquidity crisis, where was that money coming from? So I think that is a very important point in this hearing today. So that is one of the things I have learned.

As far as going forward, I think that the CME is—without a doubt, that is the biggest part of what we do as a DSRO, is to protect the integrity of our markets and our clients.

Senator MENENDEZ. So there is nothing structurally that you have learned from this?

Mr. DUFFY. I do not believe there is anything structurally wrong with the process sir.

Senator MENENDEZ. Thank you, Mr. Chairman.

Chairman JOHNSON. Senator Johanns.

Senator JOHANNS. Let me just say thank you for being here.

Mr. Giddens or Judge Freeh, either one of you maybe would be equipped to answer this. I am trying to get a perspective here just in terms of time. You said, I think, Mr. Giddens, when former Senator Corzine came on board, there were problems with this firm. They had liquidity problems and that sort of thing. As I understand it, that would have been in the scope of $200 million at that point in time? Is that what you found?

Mr. GIDDENS. No, Senator. I was just alluding to the fact that the evidence we see is that from 2008 on, MF Global was either losing money in an operating sense or was highly leveraged. And so it was a firm which had financial difficulties when Mr. Corzine came in, and that is simply to say that—the liquidity crisis was certainly not as severe as it was in the final weeks, in October of 2011.

Senator JOHANNS. That is what I was trying to get at here. Everything I have heard through hearings like this and reading testimony, et cetera, was that in the final weeks of MF Global, the sky fell in. Now, my understanding—and to me it seems so basic, you know, even having been a lawyer where you maintain a trust account, somebody gives you money, you put it in a trust account. You are not authorized to say, gosh, kind of a rough month this month, clients are not paying their bills or whatever, so I will just borrow money out of the trust account. But that is, in effect, what they did here, right?

Mr. GIDDENS. The analogy is good, but what they can do perfectly legally through fancy footwork and accounting each day is look at funds that are theoretically in a so-called trust account and say we now have excess, because money is moving in and out daily among—as we have a chart in here to indicate—between the broker-dealer, the FCM accounts, the segregated accounts, to European subsidiaries, to banks, depositories. So it is all very fluid. So the concept that there is a frozen trust account that you cannot touch is not the way it operates in the real world. And it operates in such a sense, if you do a calculation and somebody in Chicago says, well, we have calculated with have $200 million excess so we can now use that as collateral and transfer that to the broker-dealer account equally, as in the example I gave, a transfer was made from the broker-dealer segregated fund on the last day of $220 million maybe on the assumption that they had excess. But the rules of the regulators and the way this worked and maybe the way it has to work is that the money is really not frozen and can easily be moved around.

There could be much stricter safeguards, some of the things Mr. Duffy was talking about in terms of making people responsible at

the top, which I was talking about, and others, so it is not so easy for some $85,000-a-year vice president to say I have seen the calculations and, therefore, I will move $200 million from one way to the other.

Senator JOHANNS. Did you come across any indication that the firm was actually using that approach in a way that you personally would regard or you would offer an opinion that that was deceptive, it was done in a way to deceive people who were supposed to be paying attention to this or regulating this?

Mr. GIDDENS. I really have no personal opinion about that.

Senator JOHANNS. Let me ask a question then about that. You are going into this time of a personal investigation, I think is what you said, Judge Freeh, and you are going to start trying to uncover who did what and when and that sort of thing. So what are your options? If you see evidence that that practice was done in a deceptive way, just describe for the Committee the three or four things that could happen to the principals here.

Mr. FREEH. Yes. In addition to the regulators and the criminal investigators conducting simultaneous and in some ways very similar investigations and that is why we are cooperating with them to the ultimate extent possible, making available records, witnesses, waiving privileges where we can do so. But in our own investigation and our own mandate, myself as the Chapter 11 trustee and Mr. Giddens as the SIPA trustee, is to look for causes of action, and at this point nothing is off the table. So we not only look at employees and directors of the holding company as well as the subsidiary that Mr. Giddens is the trustee for, but third parties, including financial institutions, who had different collateral requirements, which changed particularly in the last several days.

So at this point, literally everything is on the table, both, you know, individual persons as well as institutions, and what we will do, maybe separately but maybe simultaneously, is make legal determinations with our lawyers about whether a viable cause of action exists and whether it is efficient to pursue that cause of action.

In my own case, representing the debtors, we may have a cause of action that would cost $10 million, but the institution or the individual has no assets, so I would have to weigh that in terms of wasting assets in the estate.

Senator JOHANNS. Thank you.

Thank you, Mr. Chairman.

Chairman JOHNSON. Senator Tester.

Senator TESTER. Yes, thank you, Mr. Chairman, and I appreciate you holding this hearing. It is not a surprise to especially Mr. Giddens. I mean, we saw Montanans' funds used to hedge wiped away because of the lack of MF Global's ability to segregate funds and keep them segregated. I think this is the eighth large bankruptcy in U.S. history, and correct me if I am wrong, the first time segregated funds have gone missing, so to speak.

I will probably get back around to Senator Corker's question because I think it is a good one, and I am not sure there is an answer to it, but we will probably do it anyway.

First of all, I want to thank all of you for testifying. I very, very much appreciate your time here today.

Mr. Freeh, you have got an incredible résumé, one that I am sure you are proud of, one that is very, very good. And in going back to the question that the Chairman asked, the very first question where he did talk about bonuses, I just want to clarify because in your statement today you said bonuses are not part of consideration now or in the past. I thought you told the Chairman nor in the future. Is that correct?

Mr. FREEH. I did, sir.

Senator TESTER. Well, thank you. And the questions that have been asked kind of add some credence to this. You say that there are about 15 employees that you have hired—and correct me if I am wrong—plus three senior executives. Is that correct?

Mr. FREEH. Yes, sir. The 15 employees remain. They were prepetition operators. They run, as I mentioned, tax activities and, you know, they are the worker bees so to speak.

Senator TESTER. Not folks, so to speak, who would be part of the problem.

Mr. FREEH. Well, we do not know at this point, but of course, we are not considering them insiders. We are considering them employees.

Senator TESTER. How about the three senior executives? Would they be considered insiders?

Mr. FREEH. Yes, they are insiders.

Senator TESTER. OK. So in the previous question that Senator Johanns asked, you said you are looking about who did what when and a potential cause of action. When you negotiate their salaries, how are you going to do it when, in fact, you are looking at them as being part of the problem, part of the so-called crooks?

Mr. FREEH. Well, we have not made any determinations, of course, in that regard. The salaries are set, Senator. We are not negotiating salaries.

Senator TESTER. Who sets them?

Mr. FREEH. Well, they were set at the time of the petition reverting back to their base salaries. So each employee, including the three insiders, had base salaries which have been continued.

Senator TESTER. OK. All right. So the point I am trying to get at here—and I think I heard the answer—is, I mean, I do not really want to give any benefits whatsoever to anybody who caused this debacle, and "debacle" is not a tough enough word. Are you confident that that is the case?

Mr. FREEH. I am confident that is the case. What I did say to the Chairman with respect to the 15 noninsiders—for instance, the group that is working now to get a very important and valuable tax refund back to the estate—you know, I need to maintain them or else the alternative would be to go out and hire, you know, an accounting firm at three or four times the cost. So that is the balance that I am conducting, but it is on that noninsider level, and there are only, as I said, 15 critical people that I have to balance a fair and competitive salary for.

Senator TESTER. OK. Mr. Duffy, in your testimony you described the futures market as mostly professional, and yet Mr. Giddens suggests in his testimony that 78 percent of MF Global's claimants—I suspect some farmers and ranchers—would be seeking a return of less than $100,000. And this really is the question: Why

should farmers and ranchers trust CME in the future to regulate and be able to protect their money?

Mr. DUFFY. I think there are several reasons, sir, but first and foremost and really important is the $5.5 to $6 billion, roughly, of segregated funds that MF Global was holding, CME Group held $2.5 billion of those segregated funds. When MF Global collapsed and filed for bankruptcy, CME still held $2.5 billion of those customer funds. Our customers were made whole at the clearinghouse level. There were monies that were transferred out at the firm level, not the clearinghouse level.

With respect to what Mr. Giddens said about the $100,000 clients, there are many clients that have significantly higher balances than that. But one of the reasons why we came up with the Farmer & Rancher Protection program is there is roughly 36,000 accounts at MF Global of which 20,000-some-odd have $25,000 or $50,000 or less. So it goes a lot smaller. A lot of those are *bona fide* hedgers and ranchers. If, in fact, MF Global happened today, under our program every farmer and rancher would have been made 100 percent whole.

Senator TESTER. But it was not, and so what about those folks who are not made whole now, the little guys?

Mr. DUFFY. Again, we cannot do things—looking back, it would be considered a moral hazard. There was $158 billion of segregated funds in the futures industry, and that would be a detriment to CME or anybody else to try to guarantee that type of number.

Senator TESTER. OK. Mr. Giddens—it might just be for a second, Mr. Chairman. Mr. Giddens, there have been a lot of questions here today about a half a dozen regulators and maybe more, about what happened, what transpired, things have been talked about, poorly capitalized, liquidity problems when Mr. Corzine came on board. And we see something happen in the eighth largest bankruptcy that has ever happened where segregated funds were compromised.

Does this kind of stuff just happen or—as a policy maker, you always look to say what went wrong, what could we have done better, who screwed up. Are you to a point where you can say that? And I do not want you throwing anybody under the bus, just be honest. Are you at a point where you can say this is where the system failed, this was a regulator that either did not do their job or did do their job, or if you have got a cagey enough accountant and you can juggle the books good enough, you can get away with just about anything? Because it appears to me that—unless there is something else out there, and tell me what it is.

Mr. GIDDENS. I think that the evidence indicates that in most of the cases the individuals complied with—speaking of FCMs generally, complied with the regulations. The regulators looked at the materials. The materials were filed. But all of the failures of either broker-dealers or FCMs are for the most part caused either by fraud or by financial mismanagement. And in those percentages where this occurs, as I think was the case here, you can by hindsight look at it and say there are some things that could have been done—more frequent reporting, also I think the imposition on seniors in the firm, such as the CEO and the CFO, to say if there is a shortfall in customer funds, you may be liable, personally liable,

and, therefore, that should incentive you to have internal systems which assure you that you have enough funds. And perhaps one of the ways to do that, as is done with any kind of a normal repo or so is have excess collateral, so why not have a requirement that there be excess segregation?

So I think there are specific things that can be done to ameliorate the situation. I do not think it was just a happenstance circumstance. I think there is often a case in many bankruptcies from Enron on out where a firm is in financial trouble, and the normal controls are ignored, and people act in desperation to try to avoid these kind of problems.

I think the regulators and the reports and things required do serve a valuable purpose, but I think they can be improved.

Senator TESTER. Thank you. Thank you all for your testimony.

Chairman JOHNSON. Senator Moran.

Senator MORAN. Chairman, thank you.

Commissioner Sommers, I want to focus on CFTC. What was the conflict of interest that Chairman Gensler caused to recuse himself 5 days after the filing of the bankruptcy?

Ms. SOMMERS. I am not familiar with the specifics or what he was thinking when he decided to recuse himself.

Senator MORAN. There was not a discussion among the Commissioners?

Ms. SOMMERS. There was not a discussion.

Senator MORAN. But then there was a vote, I assume, that selected you to be the lead on MF Global?

Ms. SOMMERS. Yes, sir. The other three Commissioners voted.

Senator MORAN. But no discussion about why Chairman Gensler was no longer going to act in that capacity?

Ms. SOMMERS. No, sir.

Senator MORAN. Prior to the bankruptcy of MF Global, looking back it seems clear that MF Global was under financial stress. You can look at stock prices, the New York Fed reaction. Did the CFTC take any action to enhance its surveillance or to encourage others to enhance its surveillance prior to the filing of bankruptcy?

Ms. SOMMERS. In the week leading up to the bankruptcy filing, we had people on the ground at MF Global. Our staff in Chicago was there on the ground. But the numbers and what we look at are whether or not the firm is capitalized and whether they have the money to meet their segregated obligations to their customers. And the data that was provided to us from MF Global showed that they were in compliance up until the very last few days.

Senator MORAN. When you say you had CFTC personnel on the ground, was that an increase in personnel on the ground? Did you detect that there might be something wrong and reacted or not?

Ms. SOMMERS. We actually had people at MF Global's offices in Chicago and New York, and that is not typical.

Senator MORAN. And when did that occur?

Ms. SOMMERS. The week prior.

Senator MORAN. The week prior.

Ms. SOMMERS. Yes.

Senator MORAN. When over 99 percent of MF Global's accounts were commodity accounts, did CFTC have an opportunity to prevent SIPA from taking over the bankruptcy? And why was MF

Global Holding, the holding company, why was it allowed to file Chapter 11? Both of those instances seem to have preferred the general creditors over the segregated account holders. Did CFTC have a role in altering the decisions that were made that allowed those two things to happen, the kind of—SIPA's involvement, in my view to the detriment of the segregated account holders, and the holding company-wide bankruptcy filing. Both those worked to the detriment, it seems to me, to the segregated account holders. Did the CFTC have a role to play in those decisions?

Ms. SOMMERS. Although I was not privy to the conversations that led up to MF Global being placed into a SIPC bankruptcy proceeding, it is my understanding that when that is done and the SEC has the ability to place an entity that they believe is either in financial distress or is approaching financial distress, they have the ability to refer them to SIPC.

We do not have that same authority if an entity is a stand-alone FCM versus a broker-dealer FCM. But it is my understanding that even though the entity was a joint broker-dealer FCM and placed into a SIPA proceeding, that all of the Commission's regulations, Part 190, bankruptcy rules and regulations, those all apply, just as they would if it were just a stand-alone FCM and those, you know, were not in——

Senator MORAN. Commissioner, is what you are telling me then that my understanding that—or my suggestion that those segregated account holders were harmed by that decision is not true?

Ms. SOMMERS. My understanding is that it is not true.

Senator MORAN. Did that discussion occur prior to the filing of bankruptcy? Was CFTC engaged in this conversation about how this bankruptcy was going to occur?

Ms. SOMMERS. The Commission was informed that MF Global was going to be placed into a SIPA liquidation. We were not involved in whether or not that decision should be made.

Senator MORAN. Who at CFTC was handling the decisions related to enhanced supervision and the kind of bankruptcy or the bankruptcy proceedings—who at CFTC was handling those decisions prior to the bankruptcy?

Ms. SOMMERS. Up until November 3rd, Chairman Gensler was directing those decisions.

Senator MORAN. And since you have told me you do not know what his conflict of interest was that caused him to recuse himself 5 days after the bankruptcy, you do not have an opinion as to whether that same conflict of interest would have accrued prior to the filing of bankruptcy. Do you know if something happened between the filing of bankruptcy and the 5 days later when he recused himself that created a conflict of interest? Or is it the same conflict of interest that was there prior to bankruptcy and subsequent to bankruptcy?

Ms. SOMMERS. I do not know.

Senator MORAN. Thank you.

Mr. Chairman, thank you.

Chairman JOHNSON. Senator Shelby.

Senator SHELBY. Thank you. I apologize for missing part of your testimony, but I have a conflict, as others do. We had a markup in the Appropriations Committee, and you should not be absent

from that, as you can recall. I hope some of these questions have not been asked, but if they have, I was not here to hear them.

I will first go to you, Commissioner Sommers. During the week leading up to the bankruptcy—picking up on some of Senator Moran's questions, during the week leading up to the bankruptcy of MF Global, did Chairman Gensler ever, ever indicate to you that he was concerned about customer assets at MF Global?

Ms. SOMMERS. My recollection, Senator, is that Chairman Gensler had concerns regarding the financial condition of the company, and that is why staff were sent.

Senator SHELBY. How many times do you recall—or do you have a record of it that you could furnish to the Committee if you do not recall yourself right at the moment—did Chairman Gensler brief you and other Commissioners at the CFTC's meetings on the management of the crisis? Because that had to be a concern for the CFTC, because this was not business as usual.

Ms. SOMMERS. Right. Over the weekend prior to the filing of the bankruptcy, I recall receiving two emails from the Chairman, and then we held a closed meeting——

Senator SHELBY. And what was the substance of those emails?

Ms. SOMMERS. Just informing us that he was on——

Senator SHELBY. That there was a problem?

Ms. SOMMERS. No. Informing us that he had been on conference calls with domestic and foreign regulators regarding the potential sale of MF Global to another financial institution.

Senator SHELBY. Did he indicate great concern at that time?

Ms. SOMMERS. Not at that time, no.

Senator SHELBY. OK. Mr. Duffy, I will direct this question to you and also to Commissioner Sommers. What authorities does the Chicago Mercantile Exchange, CME, have to protect customer segregated accounts at a futures commission merchant during an emergency situation? And, Commissioner Sommers, following up on that question to Mr. Duffy, what authorities does the CFTC have to protect customer segregated accounts at a futures commission merchant during an emergency situation?

Mr. Duffy, you first.

Mr. DUFFY. Well, first and foremost, we make sure that they are in segregated compliance, and these are reports that we——

Senator SHELBY. That there will be—answer that again, if you would, just for the record.

Mr. DUFFY. I am sorry?

Senator SHELBY. What did you say, they will be—there should be segregated——

Mr. DUFFY. We get segregated reports.

Senator SHELBY. OK.

Mr. DUFFY. From MF Global, as we were getting them all along on a daily basis since they were acquired at Refco. So they were on a daily seg report voluntarily anyway. So we were getting these reports on a daily basis. There was a day lag and then you've got to tie them out over a several-day period. So these are some of the things that we do to have authorities to make sure they are in compliance. If they go out of compliance of segregation, it is a violation of CME's rules and then of the CFTC's rules.

Senator SHELBY. Were some of those reports you were getting, as you look back, were they misleading or were they a little more than that or what?

Mr. DUFFY. The latter, sir. They were a little more than that. We were told on one report given to us on a Thursday that they had $200 million in excess seg. After they had announced that the money was missing on Sunday evening——

Senator SHELBY. Was that true?

Mr. DUFFY. It was then true that they gave us the right report saying they were 200 deficit. They gave it to us on the following Monday. So they definitely—from the prior Thursday. So the reports were definitely inaccurate.

Senator SHELBY. So that is misleading you, right?

Mr. DUFFY. It was very misleading to us, sir. Yes, sir.

Senator SHELBY. OK. Commissioner Sommers, a question to you, the same thing.

Ms. SOMMERS. We have never had this type of situation in the past, but if we were ever in a situation where we believed that a company was in a situation where they could not meet their obligations, the Commission could seek legal action to have a receiver appointed in an emergency situation.

Senator SHELBY. I will direct the same question to both of you. In the area of protection of customer segregated accounts, Commissioner Sommers and Mr. Duffy, both of your organizations, as I understand it, had staff on-site at MF Global's Chicago offices the weekend before the firm's bankruptcy filing. What steps did your agency—I will start with you, Commissioner Sommers—take to protect customer assets prior to learning that customer assets were missing? And what date and time did staff in your agencies first learn that there was a possible or probable shortfall in the customer segregated accounts? And after you learned of the missing consumer assets, what specific steps did each of your agencies take to ensure that customer funds were not improperly transferred over the weekend? That is when it seems there was more than a little mischief done.

Commissioner Sommers, you first.

Ms. SOMMERS. So the first question with regard to what our staff was doing, although the Commission and the DSRO receive daily segregation reports, those reports only list the amount of money that the FCM owes to customers, what their obligation would be there. Our staff was in the process of trying to get supporting documentation from MF Global to be able to make sure that they actually had that money in the bank.

Senator SHELBY. You had that conversation you testified to earlier, either personally or some communication by email, from Chairman Gensler that obviously there was more than a little concern at your office regarding MF Global. Is that right?

Ms. SOMMERS. Well, I think that——

Senator SHELBY. You did not think everything was OK at MF Global after you talked to or you read the emails of Chairman Gensler, did you?

Ms. SOMMERS. I think in the beginning the reason why he sent staff to the offices of MF Global is so that we could receive the sup-

porting documentation to make sure, to do the tie-back of the segregated accounts and to make sure that that money was there.

Senator SHELBY. Because there was concern at your agency about MF Global.

Ms. SOMMERS. Right.

Senator SHELBY. Where the money was coming from and what money they had and so forth.

Ms. SOMMERS. Right. So——

Senator SHELBY. Is that correct?

Ms. SOMMERS. That is true, and the documentation and the data that they provided to us showed us that they were in compliance. So over the weekend——

Senator SHELBY. But that was not true, was it?

Ms. SOMMERS. That was not true.

Senator SHELBY. Did you have a suspicion at that time it was not true?

Ms. SOMMERS. I do not believe that staff had suspicion that they were not in compliance. Over the weekend, the staff was in the process of filing all of the documents that we would need to file in order to make a transfer possible, so customers from MF Global, if there was a financial institution that would purchase the FCM, that those customer accounts could be transferred with our approval. So we were drafting those documents in order to make that transfer of customer positions possible. We were not informed—the Commission was not informed until Monday morning of October 31st that there was a shortfall in customer segregation——

Senator SHELBY. But were you ever concerned that there might be some things wrong at MF Global? Obviously, something had to come up on your radar.

Ms. SOMMERS. Absolutely. We were concerned but never—I do not believe I ever thought that one of the concerns should be that there would be a shortfall in customer segregation.

Senator SHELBY. Mr. Duffy, do you have any comments on that?

Mr. DUFFY. I will echo Commissioner Sommers for the most part, and my recollection of what happened was we also had people on the round tying out, validating the reports against bank records and everything else, and we got through Friday into Saturday, and we still had people on the ground. And then we were told that there was an accounting error, as we referenced in my earlier testimony last year, of $900 million. And so everybody was trying to put the company——

Senator SHELBY. An accounting error of 900——

Mr. DUFFY. Yes, I found that pretty staggering myself.

Senator SHELBY. How much, $900 million?

Mr. DUFFY. $900 million, yes. So some people felt it was too big, it had to be an accounting error. There were others of us that thought it was too big and it could not be an accounting error. So I was in the latter camp.

Senator SHELBY. Well, did that send a lot of anxiety through your organization?

Mr. DUFFY. It sent a lot of anxiety, but I think people felt fairly confident that there was no way that it was not an accounting error, and the company was going to be whole and segregation——

Senator SHELBY. Were the people wrong that thought that?

Mr. DUFFY. People were dead wrong, sir.

Senator SHELBY. Dead wrong.

Mr. DUFFY. Dead wrong.

Senator SHELBY. Mr. Giddens, you are the MF Global trustee, right?

Mr. GIDDENS. Yes, sir.

Senator SHELBY. And as trustee, just for the record, what is your portfolio? What are you supposed to do as the trustee for MF Global, Inc.?

Mr. GIDDENS. Well, I am appointed the equivalent of a Chapter 7 liquidating trustee, and I have the same powers as a Chapter 7 trustee for the FCM and also for the broker-dealer.

Senator SHELBY. OK.

Mr. GIDDENS. My job is to marshal the assets of the broker-dealer estate and to pay them out as required by law. They are a sacrosanct property, which is really not part of the estate, which belongs to customers—the commodities customers' funds and also the securities customers' funds. And there are very detailed provisions of both the CFTC Act and also the SIPA Act which governs how you calculate those claims and pay them out.

The big distinction and the big difference and the reason that, as Mr. Cook of the SEC has pointed out, some of the securities customers have been paid in full is the existence of the resources of the SIPA fund which provides up to an additional $500,000 to cover losses in an account.

Senator SHELBY. Is that $500,000 per account?

Mr. GIDDENS. Yes, sir.

Senator SHELBY. OK.

Mr. GIDDENS. Yes, $250,000——

Senator SHELBY. What is the average account?

Mr. GIDDENS. The average securities account——

Senator SHELBY. At MF Global.

Mr. GIDDENS. At MF Global, probably—just doing the calculation in my head, it was probably $1 million or more.

Senator SHELBY. OK.

Mr. GIDDENS. The commodities accounts, I think as we indicated, 75 percent were less than $100,000 and probably 93 percent of the commodities accounts were less than $1 million.

Now, in both cases there were significant numbers of commodities customers and securities customers who in the last weeks transferred their accounts from MF Global to other solvent firms.

Senator SHELBY. And why did they do this? Was there concern in the marketplace about MF Global at that time?

Mr. GIDDENS. Absolutely. Its credit had been downgraded and——

Senator SHELBY. And do you know of your own account, of your own knowledge, that that concern in the marketplace extended to Chicago, to the Commodity Futures Trading, or to the SEC, or to the CME?

Mr. GIDDENS. Certainly it was in the major newspapers that——

Senator SHELBY. Yes, everywhere.

Mr. GIDDENS. ——the firm was experiencing trouble. Whether anyone suspected that there was a shortfall in segregation, I do not

know that. But I do know that because of downgrading and rating and losses, many of the larger accounts left the firm.

Senator SHELBY. People were leaving ship, weren't they?

Mr. GIDDENS. Absolutely.

Senator SHELBY. OK. Your written testimony, Mr. Giddens, provides an overview of large cash movements at MF Global during October 2011. Were there any large transfers—you talked about some of the others, alluded to them—from MF Global's customer segregated accounts to the firm's own accounts while multiple regulators were on-site at MF Global starting on October the 27th?

Mr. GIDDENS. The answer is yes. There were billions of transfers in and out of the firm and from the various accounts.

Senator SHELBY. And the regulators were on-site there.

Mr. GIDDENS. Yes, sir.

Senator SHELBY. OK. Were there any subsequent large transfers out of MF Global's own accounts to pay counterparties?

Mr. GIDDENS. Certainly during the period of October 27th through October 31st, yes.

Senator SHELBY. OK. Mr. Giddens, you recently announced that you would pursue litigation in the United Kingdom to recover approximately $700 million of customer funds. What is your best guess or your judgment for how long it will take for MF Global customers to recover, if they do, the $700 million that is trapped in the U.K.? And will it take weeks, months, or years and so forth? Just your judgment.

Mr. GIDDENS. The petition to commence the case is due to be filed shortly. How quickly and how the court determines how the litigation is held, what discovery is required and the like, is unknown at this time. We will try to expeditiously get a decision from the court.

We had a similar situation in the Lehman case in which our position was that funds that were with the Lehman U.K. broker-dealer were segregated customer funds—these happened to be securities funds, and that was opposed by the English regulators. And that process, because of appeals to three courts, took almost in excess of 2 years until there was a final decision. I hope that will not be the case here.

Senator SHELBY. What is your best judgment on how long it will take to recover the remaining $900 million in customer funds?

Mr. GIDDENS. We have recovered through closeouts with some parties some portion of that already.

Senator SHELBY. How much have you recovered of the $900 million, roughly? You can correct the record, but just give your judgment.

Mr. GIDDENS. I believe about in excess of $500 million. But I am not sure.

Senator SHELBY. OK. But you will furnish the correct——

Mr. GIDDENS. We will happily supply supplemental information on that.

Senator SHELBY. Commissioner Sommers, I would like to come back to you. In an attempt to justify his MF Global recusal, Mr. Gensler stated that he did not want his relationship with the MF Global CEO Jon Corzine to "be a distraction." Did Mr. Gensler, Chairman Gensler, ever express any concern that his relationship

with Mr. Corzine would be a distraction from any previous matter involving MF Global, including matters related to CFTC Rule 1.25 dealing with investment of customer segregated funds?

Ms. SOMMERS. Not that I am aware of.

Senator SHELBY. You do not recall?

Ms. SOMMERS. No.

Senator SHELBY. Have you searched your records and your emails and everything else?

Ms. SOMMERS. We have.

Senator SHELBY. OK. Mr. Gensler also stated, and I will quote him, that he "will not participate in any enforcement-related matters involving MF Global and any matter directly related thereto." Those are his words. This language appears from reading it to prohibit him from participating in any of the CFTC's efforts to develop recommendations based on lessons learned from the collapse of MF Global. Do you agree or disagree?

Ms. SOMMERS. Senator, we, my staff——

Senator SHELBY. In other words, he cannot have it both ways. He is either in the game or out of the game. He is saying here he is out of the game as Chairman. Is that correct? Is that the way you read the language?

Ms. SOMMERS. We have sought direction from the General Counsel of the agency on my delegation, and we are told that my delegation does not go toward the policy recommendations, that the Chairman would be handling them.

Senator SHELBY. I know my time is moving on, but I have another question that I need to ask Mr. Giddens as trustee.

On April 4th, Mr. Giddens, you provided an update on your investigation of JPMorgan Chase, which is MF Global's largest creditor, regarding the MF Global funds in its possession. You stated that you and JPMorgan—and these are your words—"are presently engaged in substantive discussions regarding the resolution of claims."

Is it your expectation that some of these funds will be returned from JPMorgan Chase to MF Global customers? And when can MF Global customers expect a resolution of claims against JPMorgan, if they can?

Mr. GIDDENS. I believe that we have a solid basis for seeking a recovery of some of the funds that were transferred to JPMorgan. As to how that decision ultimately will be made, if we do not reach a consensual conclusion, it will probably have to be resolved by bankruptcy Judge John Glenn, and how long that will take is difficult to predict. But we would not be exchanging information and engaging in really confidential discussions about legal arguments unless we thought we had a good prospect of recovering something from them.

Senator SHELBY. Mr. Chairman, could I ask Mr. Freeh one quick question, if I could?

Chairman JOHNSON. Yes.

Senator SHELBY. Mr. Freeh, you are the trustee of MF Global Holdings. Is that correct?

Mr. FREEH. Yes, sir.

Senator SHELBY. So is it your responsibility to protect the corpus of assets of what is left of MF Global Holdings?

Mr. FREEH. Yes, MF Global and the other debtors that are in Chapter 11, of which I am the trustee, exactly, to get the assets and get them back to the creditors if possible.

Senator SHELBY. OK. Thank you, Mr. Chairman.

Chairman JOHNSON. I would like to thank our witnesses for their testimony today. It is important that Congress continues to evaluate the lessons learned from the collapse of MF Global and to discuss the important issues raised at today's hearing. I look forward to working with my colleagues to help ensure that we can better protect customer accounts and improve future regulatory coordination.

This hearing is adjourned.

[Whereupon, at 11:51 a.m., the hearing was adjourned.]

[Prepared statements supplied for the record follow:]

PREPARED STATEMENT OF CHAIRMAN TIM JOHNSON

Today's hearing will examine the lessons learned from the collapse of MF Global. The misuse of customer accounts by one of the world's largest commodities and derivatives brokers has shaken confidence in our markets and deserves a thoughtful discussion of how to better protect farmers, ranchers and investors going forward.

But before we get to these important issues, I would like to express my deep concern that almost 6 months after MF Global's bankruptcy, thousands of former customers—including hundreds of South Dakotans—still have not recovered the $1.6 billion removed from what should have been protected customer accounts. I know that the trustees, regulators, as well as the FBI and Justice Department, continue to investigate what happened in the final chaotic days of MF Global, but these customer funds must be returned without further delay to their rightful owners and those individuals and executives responsible for transferring these funds must be held accountable to the full extent of the law. Lastly, it is not acceptable for MF Global executives to be given bonuses when customers have not recovered funds improperly taken from them by MF Global—and I thank Senator Tester for his leadership on this issue.

Since the collapse of MF Global in October 2011, my staff has worked closely with Senator Shelby's staff in conducting extensive interviews and due diligence with the regulators, self-regulatory organizations and other parties involved in overseeing MF Global and its bankruptcy. We have also coordinated with the Senate Agriculture Committee—which has primary jurisdiction over matters involving commodities—in holding a series of bipartisan briefings for all Senate staff with representatives of many of the organizations before us today to help our constituents impacted by the firm's downfall.

As investigators seek to recover MF Global customer funds and hold accountable those responsible for any wrongdoing, this Committee will focus our attention on preventing future abuses and the other critical public policy issues raised by the collapse of MF Global.

Today's hearing provides a unique opportunity to ask an important set of questions: how can we strengthen protections for customer accounts at futures commission merchants or broker dealers, including those firms that hold U.S. customer funds abroad? Given the size of the shortfall in MF Global's customer accounts, what should Congress understand about the idea of extending to commodity accounts similar insurance protections that are currently available to securities accounts under the Securities Investor Protection Act? And how we can continue to improve regulatory oversight and coordination for large, complex global financial institutions?

MF Global may also provide some early lessons about the Wall Street Reform Act since it is the first collapse of a major financial institution since the law's passage. For example, the story of MF Global teaches us that effective customer protection and market oversight demands that we fully fund our regulatory cops on the beat. In hindsight, there is little doubt that the regulators responsible for monitoring MF Global should have taken additional steps. But shortchanging the CFTC or SEC of much needed funding will only force them to delegate even more authority to self-regulatory organizations in a way that could impair effective market surveillance. When funding cuts prevent regulators from inspecting firms or assigning necessary staff to monitor crises, the American people and market confidence pay the price.

Additionally, a key pillar of the Wall Street reform bill was to end "too big to fail"—and if MF Global demonstrates anything, it is that those who take risky bets that bring down their companies are now free to fail and will not receive any more taxpayer bailouts.

PREPARED STATEMENT OF JAMES W. GIDDENS

TRUSTEE, SECURITIES INVESTOR PROTECTION ACT LIQUIDATION OF MF GLOBAL INC.

APRIL 24, 2012

Chairman Johnson, Ranking Member Shelby, and Members of the Committee, thank you for inviting me to testify today. My name is James Giddens. I am the court-appointed Trustee for the Securities Investor Protection Act (SIPA) liquidation of the failed broker-dealer, MF Global Inc. I am also the Trustee for the liquidation of the failed broker-dealer, Lehman Brothers Inc., and have extensive experience in broker-dealer liquidations. As a SIPA Trustee, I have all the powers and duties of a trustee liquidating a futures commission merchant under Chapter 7 of the Bankruptcy Code.

Considerations

I would like to provide to this Committee some considerations on topics that may merit further study and input from regulators, industry experts, and members of the public. My comments are based on my experiences as Trustee generally, as well as my discussions with former MF Global customers, a group that includes thousands of America's farmers and ranchers, many of whom are undoubtedly your constituents. I understand the frustrations of the many former MF Global customers. My goal is to return as much money to customers as possible, as quickly as possible. All of us hope to avert a repeat of the MF Global catastrophe, or, at a minimum, alleviate its consequences, and with this goal in mind, I offer the following topics for consideration:

- Strict liability for the senior officers and directors of a commodities broker.
- Establishment of a commodities customer protection fund.
- Suitability requirements for commodities customers.
- Segregation requirements in excess of 100 percent of customer funds; notice requirements for the withdrawal of "excess" segregated funds.
- Complete segregation of 30.7 "secured" funds and elimination of alternative calculation.
- Improved international cooperation.

Strict Liability for Senior Officers and Directors

The failure of MF Global Inc. was in part due to a failure to maintain integrated systems for tracking liquidity and the movement of funds, a lack of supervision of key treasury functions, fragmentation of responsibility, and inattention to the details of maintaining the segregation of customer funds at senior levels of the company. Because regulations require futures commission merchants (FCMs) to segregate customer funds at all times, it may be appropriate to impose civil fines in the event of a regulatory shortfall on the officers and directors who are responsible for signing the firm's financial statements.

Consideration should be given to requiring the chief executive officer, the chief financial officer, the chief compliance officer, and the general counsel of an FCM to certify not only their company's financial statements but also their compliance with customer segregation requirements on a frequent and continuing basis. Consideration should also be given to making the officers responsible for establishing and overseeing a company's internal controls and procedures and certifying that they have done so. Where there is a shortfall in customer funds, Congress should consider making the officers and directors of the company accountable and personally and civilly liable for their certifications without any requirement of proving intent and without permitting them to defend on the basis that they delegated these essential duties and responsibilities to others.

Commodities Customer Protection Fund

The liquidation of MF Global Inc. would have played out differently had there been even a modest protection fund for commodities customers. The statistics we have gathered in the claims process demonstrate that the accounts of more than two-thirds of the customers who filed claims represent only 3 percent of the total amount that MF Global was required to segregate for commodities customers, or no more than $200 million in total. Of the commodities customer claims received by my office, 78 percent seek a return of less than $100,000. Thus, a fund limited to protecting these smaller accounts—representing many farmers and ranchers—could be of relatively modest size but would suffice to make these customers whole very quickly even in a case with a shortfall the size of MF Global's. With such a fund in existence, three-quarters of MF Global's commodities customers would not have been subject to any loss and could have been made whole within days of the bankruptcy filing.

A protective fund of this nature could be modestly funded and maintained at a minimal cost until such time as necessary to advance funds to customers, thereby allowing them to resume trading with little or no delay. The fund could be replenished by industry assessments when needed to satisfy claims in FCM failures.

Suitability Requirements for Commodities Customers

MF Global's commodities customers included farmers, ranchers, and members of the general public. Commodities trading is clearly an important part of the economy that, among other things, assists our vital agricultural base in hedging risk and funding itself. However, my staff and I have heard from many claimants across the spectrum of day traders and others who appear to have invested their retirement accounts and life savings in products in the U.S. and abroad that they may not have

fully understood. We have heard from some former MF Global customers who have said they did not understand the account statements they received from MF Global even when it was in business.

Under current regulations, commodities customers are not subject to suitability requirements, such as those that the Securities and Exchange Commission has approved and are applicable to securities customers. Suitability requirements could help ensure that there is reasonable basis to believe that a transaction or investment strategy is suitable for a commodities customer, based on information about that customer obtained through reasonable diligence by the FCM.

Segregation Requirements In Excess of 100 percent of Customer Funds; Notice Requirements for Withdrawal of Residual Balances

Consideration should be given to requiring an FCM to segregate an amount in excess of 100 percent of customer funds. Requiring FCMs to post proprietary funds beyond the margin provided by customers could help ensure that there is a sufficient cushion at all times for commodities customers. Consideration should also be given to implementing specific review and sign-off requirements by the CFO or other senior officers whenever an FCM seeks to withdraw even what are believed to be residual or excess segregated funds from a segregated (or secured) account when the withdrawal exceeds a certain dollar amount or percentage of either the account or the calculated excess.

Complete Segregation of 30.7 Funds

Under current rules, FCMs are not required to calculate "secured" amounts for customer funds held for trading on foreign exchanges per Commodities Futures Trading Commission Rule 30.7 (30.7 funds) the same way that they must calculate "segregated" amounts for customer funds held for trading on U.S. exchanges per section 4d of the Commodity Exchange Act (4d funds). Specifically, the rules allow a FCM to calculate the "secured" amount according to one of two methods:

A. Net Liquidating Equity Method: the net liquidating value of the net equity of all customer accounts plus the market value of any securities held in customer accounts; or

B. Alternative Method: a risk-based measurement based on margin required, plus or minus the unrealized gain or loss on futures positions, plus long option value, minus short option value.

In the case of MF Global, reliance on the Alternative Method in the time period leading up to the liquidation resulted in substantially fewer funds being segregated than under the Net Liquidating Equity Method. This allowed the FCM to believe that it was in regulatory compliance, with hundreds of millions of dollars to spare, even when the amount in segregation was actually in or perilously close to being in deficit. If FCMs were required to compute the secured amount under the Net Liquidating Equity Method, it could help ensure that all customer funds are properly segregated at all times and eliminate a difference in treatment among customers of which most customers are unaware.

International Cooperation

The collapse of MF Global, like the collapse of Lehman Brothers, has revealed significant gaps between protections afforded customers in U.S. and foreign countries, such as the United Kingdom, arising largely from differences in insolvency laws and the absence of clear legal precedent. Though there may not be a one-size-fits-all solution for these issues, customers would benefit from greater harmonization of rules governing the segregation of customer funds and treatment of omnibus accounts. A jurisdiction outside the United States should only be approved as a location for the deposit of U.S. customer segregated funds if there are adequate assurances that other Governments and firms themselves are requiring and effecting segregation consistent with the representations made by a U.S. broker to its customers.

When a company like MF Global or Lehman Brothers fails, it is important that property segregated in one country for customers in another country is returned to the trustee or administrator in the country where the customer resides. In my experience, however, these tend to be the last issues to be resolved, which often require protracted litigation. In the case of MF Global, I have been engaged in active discussions since November with the administrators for the estate of MF Global U.K. Ltd. concerning the return of approximately $700 million of segregated customer property. I have filed a client claim in that proceeding seeking the return of all such segregated property, and have engaged in an exchange of information with the British administrators regarding this claim. That process has shown that there is a dispute as to whether the customer property that is the subject of my claim was or

should have been segregated under English law. I believe that is in the best interests of MF Global Inc.'s former commodities customers that this dispute be resolved by the court, and the British administrators, at my request, have agreed to seek direction from the English court on these issues. Though I will press to have this litigated as expeditiously as possible, adjudication and resolution will likely take significant time and expenditure of resources, all the while holding up the possibility of substantial distributions to 30.7 customers in the United States.

Update on Trustee's Investigation

As Trustee, my statutory mandate as the customers' advocate is to preserve and recover MF Global Inc. customer assets so that they can be returned to the rightful owners and to maximize the estate for all stakeholders.

As part of my statutorily mandated duty, I am investigating the extent of and reasons for any shortfall in customer funds. This includes a deliberate, thorough, and independent investigation of the complex cash movements made by MF Global Inc. prior to its liquidation. My investigative team consists of counsel experienced in broker-dealer liquidations and expert consultants and forensic accountants from both Deloitte & Touche and Ernst & Young. All efforts are conducted under the supervision of the Bankruptcy Court and are coordinated with the United States Department of Justice, the CFTC, the SEC, and SIPC.

On February 6, 2011, I issued a preliminary report on the status of my investigation, which preliminarily determined that MF Global Inc. had a shortfall in commodities customer segregated funds beginning on Wednesday, October 26, 2011, and that the shortfall continued to grow in size until the bankruptcy filing on Monday, October 31, 2011. As detailed in the preliminary report, my office has traced substantially all of the cash transactions made in and out of MF Global Inc. in the last week before bankruptcy, totaling more than $105 billion. At the request of the Committee, I have attached as an appendix a timeline of key events leading up to MF Global's bankruptcy filing based on my investigation.

My investigation has included thorough review of the actions of JPMorgan Chase, N.A., regarding JPMorgan's activities in connection with MF Global. JPMorgan has cooperated with my investigation, which has included witness interviews and review of extensive documentation by my staff, including attorneys and forensic accountants from Ernst & Young. My office and JPMorgan are presently engaged in substantive discussions regarding the resolution of claims.

I also believe, based on my investigation of conduct, allocation of responsibilities and reporting with respect to the segregated customer accounts, that there may be claims against certain responsible individuals at MF Global Inc. and MF Global Holdings Ltd. for, among other things, breach of fiduciary duties owed to both MF Global Inc. and its customers, and violations of the segregation requirements of the Commodity Exchange Act. I may pursue these legal actions separately or in conjunction with commodities customers.

As I move forward with my investigation, I will continue to provide updates to the Court and public on my findings and conclusions.

Status of Customer Distributions

My office has distributed nearly $4 billion to former MF Global Inc. retail commodities customers with U.S. futures positions via three bulk transfers:

- Within days of the bankruptcy, I received court approval for the transfer of 10,000 commodities customer accounts with three million open positions, along with approximately $1.5 billion in collateral associated with those positions at the time of the bankruptcy. These open positions had a notional value of $100 billion. A serious disruption in markets was avoided by the transfer.
- A transfer of 60 percent of the cash attributable to approximately 15,000 customer commodity accounts with cash only in the accounts, totaling approximately $500 million, was completed in November.
- In December and January, a third transfer occurred that moved approximately $2 billion to restore 72 percent of U.S. segregated customer property to all former MF Global Inc. retail commodities customers with U.S. futures positions.

My office has received 26,778 total commodities claims and has received over 4,500 additional general creditor claims that were likely misfiled, which will be treated as commodities claims. I expect that the total number of unique claims from former commodities customers (accounting for duplicates and amendments) will be approximately 23,000.

My office has determined and issued letters of determination for nearly 22,000 commodities claims, which is over 90 percent of the expected total claims.

In addition to the completed distributions, I have filed a motion with the Bankruptcy Court seeking authority for a distribution of up to approximately $600 million of customer property held as segregated by MF Global Inc. for its former commodities futures customers who traded on U.S. exchanges (4d funds); up to approximately $50 million of customer property associated with commodity transactions in foreign markets (30.7 funds); and up to approximately $35 million of customer property to a domestic delivery class, which we have identified as consisting of physical customer property that has been or will be reduced to cash in any manner.

I have also received Court approval to sell and transfer approximately 318 active retail securities accounts, which is substantially all of the securities accounts at MF Global Inc. Nearly all securities customers have received 60 percent or more of their account value and already 194 of former MF Global Inc. securities customers have received the entirety of their account balances because of a SIPC guarantee.

Conclusion

My office has made every effort to communicate directly and frequently with customers. Our Web site includes updates, court filings, and claims information, including a section addressing the common questions being asked by customers in calls or other communications to my staff. My staff and I are answering customer calls and emails and holding meetings with customer groups and counsel. I have established special hotlines for customers to call with questions about their claims determinations, the treatment of their physical property, or tax issues.

If your constituents have any questions, I encourage them to visit MFGlobalTrustee.com, email my staff at MFGITrustee@hugheshubbard.com.

I fully understand the frustration of many former MF Global Inc. customers, some of whom you have heard from directly. When a broker-dealer fails under the unprecedented circumstances surrounding MF Global's demise, the liquidation is necessarily complex. My office has been working tirelessly with speed and diligence to identify ways to return assets to customers to the full extent of our ability under the applicable provisions of SIPA, the Bankruptcy Code, and CFTC regulations.

Thank you Chairman Johnson, Ranking Member Shelby, and other Members of the Committee for the opportunity to testify before you and to submit this testimony for the full record of the hearing.

APPENDIX

SIPA TRUSTEE'S PRIMARY DUTIES

1. Under the Securities Investment Protection Act ("SIPA"), the Trustee's obligations are to preserve assets and identify and marshal other assets to maximize the estate in a manner that is fair to all customers and other creditors.

    - In the SIPA liquidation of MF Global Inc., the Trustee has taken immediate steps to protect customers and set in place the process for an orderly and efficient liquidation. The Trustee's team is working to get money back to customers as quickly as possible following the failure of MF Global Inc.

    - The Trustee was able to use his powers under SIPA, with the approval of the Bankruptcy Court, to transfer large portions of commodities customers' accounts beginning within days of the SIPA filing and to establish an expedited customer claims process which has already determined over ninety per cent of all commodities claims in accordance with the Commodities Exchange Act and the applicable CFTC regulations.

    - The Trustee's goal remains returning as much customer money as possible, as quickly as possible, in a manner that is fair to all customers and that is consistent with the law.

2. A SIPA Trustee has all the powers and duties of a trustee liquidating a futures commission merchant under Chapter 7 of the Bankruptcy Code.

3. A SIPA Trustee has the specific and important additional power and duty to conduct an investigation and prepare a report concerning the acts, conduct, property, liabilities, and financial condition of the debtor, the operation of its business, and any other relevant matter. The importance and applicability of this power to commodities liquidations was approved in an opinion by the Bankruptcy Court in the MFGI liquidation.

    - In the SIPA liquidation of MF Global Inc., the Trustee has already filed a preliminary report on the status of his investigation with the Bankruptcy Court (available on the Trustee's website, www.mfglobaltrustee.com) and has used this investigatory power to seek to recover funds and aid law enforcement investigations.

KEY EVENTS REGARDING THE FINAL WEEK OF MF GLOBAL

The Trustee's investigation has preliminarily concluded that the following key events occurred from October 24, 2011 to October 31, 2011, the week preceding MF Global's bankruptcy filing:

1. Cash transactions totaling more than $105 billion were made in and out of MF Global Inc. during its final week. MF Global Inc. also executed securities transactions totaling more than $100 billion, including the liquidation of customer and proprietary securities.

2. In the normal course of business at MF Global, transactions regularly moved between accounts, and funds believed to be in excess of segregation requirements in the commodities segregated accounts were used to fund other daily activities of MF Global. In the past, such transfers were in amounts of less than $50 million, but as liquidity demands increased and could not be met from internal sources in the final week prior to the bankruptcy, much larger amounts were used, apparently with the assumption that funds would be restored by the end of the day.

3. By Wednesday, October 26, as the result of increasing demands for funds or collateral throughout MF Global, funds did not return as anticipated. As these withdrawals occurred, a lack of intraday accounting visibility existed, caused in part by the volume of transactions being executed. The 4(d) U.S. segregated commodity customer account appears to have reached a deficit condition on Wednesday, October 26 that continued through to MF Global's bankruptcy.

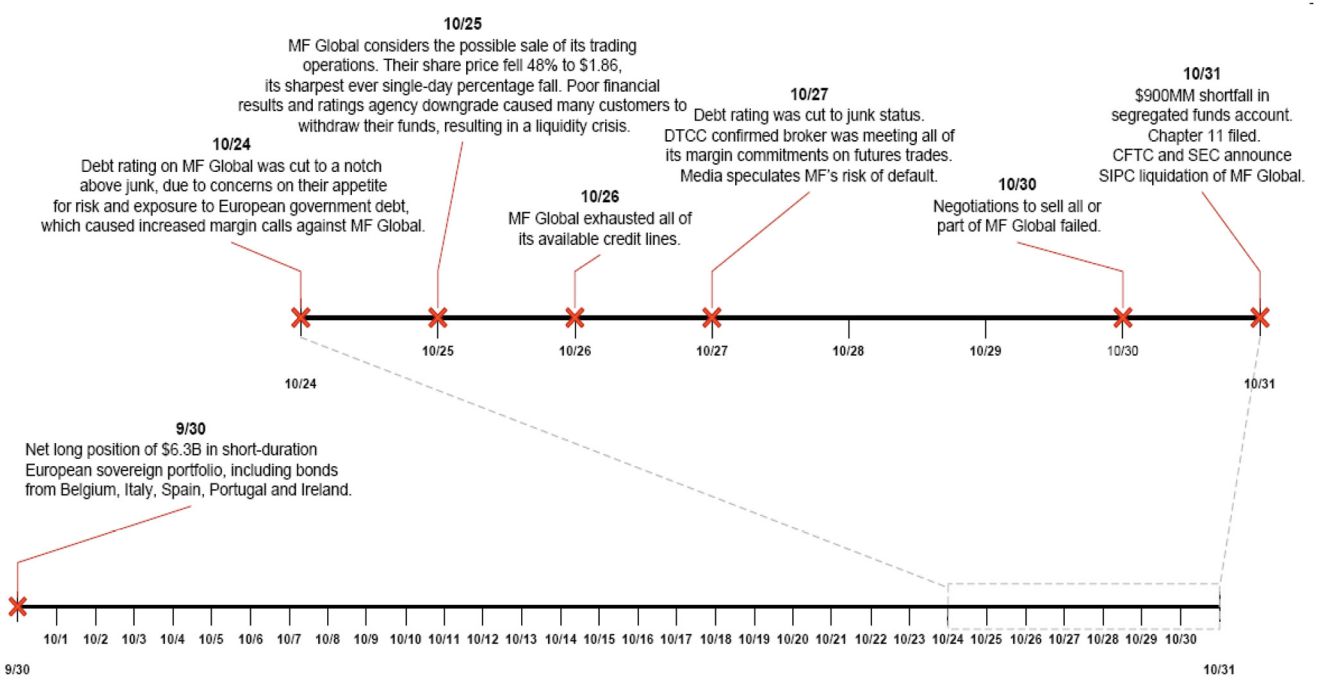
4. The number of transactions executed by MF Global during its final week escalated to unprecedented volumes. The rush to meet funding needs for collateral, margin and customer liquidations led to billions of dollars in securities sales, draws on credit facilities, and a web of inter-company loans across affiliates, some foreign.

5. The company's computer systems and employees had difficulty keeping up with the unprecedented volume of transactions. A number of transactions were recorded erroneously or not at all. So called "fail" transactions – where either the buyer or seller fails to deliver the cash or the security, respectively – were five times the normal volume during the firm's final week.

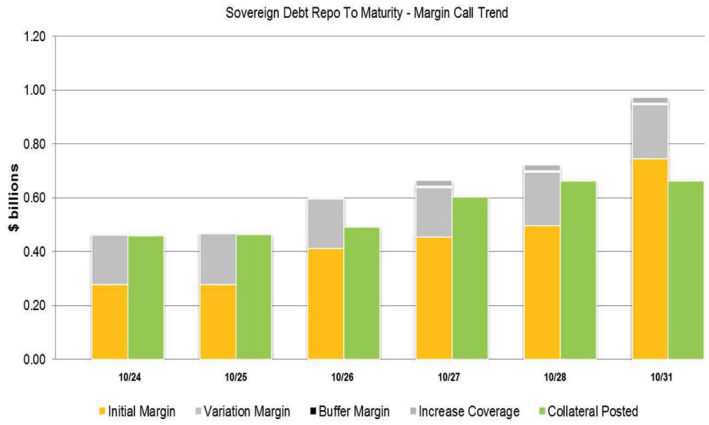
6. A confluence of factors contributed to the deterioration of MF Global's liquidity position. The exposure to European sovereign debt causing FINRA to require additional net capital contributions, coupled with the announcement of a large write off and disappointing quarterly results, triggered credit downgrades by Moody's, Fitch and S&P.

7. The parent company, MF Global Holdings Ltd., struggled to continue to operate and even to sell the business, but MF Global Inc. appears to have remained in a shortfall of commodity customer segregated funds virtually continuously until its parent filed for Chapter 11 protection on Monday, October 31. The Securities Investor Protection Act (SIPA) proceeding was commenced against MF Global Inc. later that afternoon.

Timeline of MF Global Events

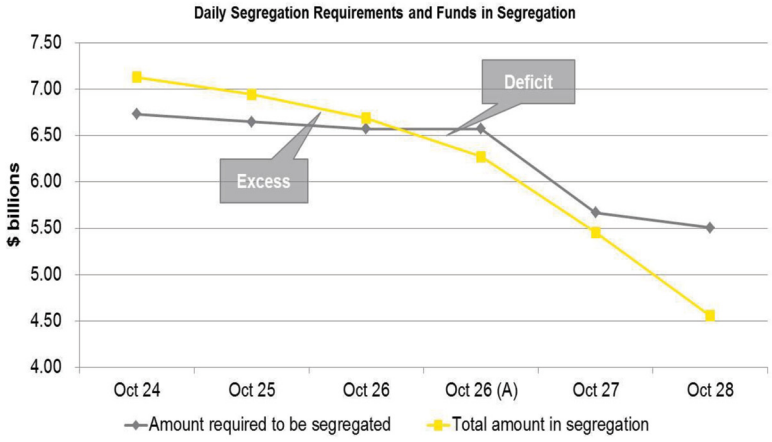


Increased margin calls



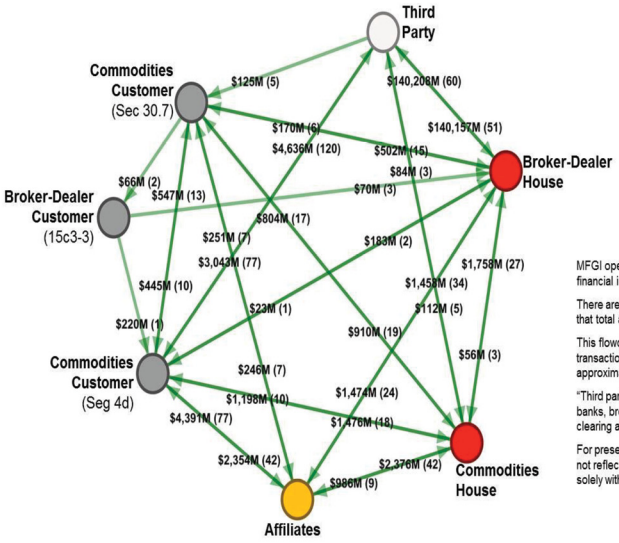
Date	Initial Margin	Variation Margin	Buffer Margin	Increase Coverage	Total Margin	Collateral Posted	Margin Call
10/24	278,049,205	182,979,874	5,000,000		466,029,079	457,962,898	8,066,181
10/25	277,302,875	188,277,470	5,000,000		470,580,345	464,694,118	5,886,227
10/26	410,963,534	185,592,415	5,000,000		601,555,949	492,732,015	108,823,934
10/27	454,624,390	182,811,558	5,000,000	23,280,469	665,716,417	604,003,047	61,713,370
10/28	495,975,763	199,344,353	5,000,000	23,219,740	723,539,856	663,925,523	59,614,333
10/31	745,975,763	199,344,353	5,000,000	23,219,740	973,539,856	663,925,523	309,614,333

Customer funds in segregation: excess turns into deficit



(A) Corrected for MFGI error
A shortfall in segregated customer funds occurred during 10/26. The calculation originally prepared by MFGI contained an error. Cash deposits in segregated funds bank accounts were erroneously overstated.

Consolidated Overview of Cash Movement
MF Global Inc. 10/1 – 10/31



MFGI operated 47 bank accounts held at 8 financial institutions.

There are 840 transactions > $10 million that total approximately $327 billion.

This flowchart excludes roughly 20,000 transactions < $10 million that total approximately $9 billion.

"Third party" includes customers, lending banks, brokerage firms, exchanges, and clearing agents.

For presentation purposes, this chart does not reflect certain transactions that occurred solely within a related grouping of accounts.

This reflects cash movement only. Investigation is ongoing to trace correlated securities, collateral and other assets.

PREPARED STATEMENT OF LOUIS J. FREEH

TRUSTEE, MF GLOBAL HOLDINGS LTD.

APRIL 24, 2012

Chairman Johnson, Ranking Member Shelby, and distinguished Members of the Committee, my name is Louis J. Freeh and I am appearing before you today in my capacity as the Chapter 11 Trustee of MF Global Holdings Ltd. and five of its subsidiaries.

On October 31, 2011, MF Global Holdings Ltd. and MF Global Finance USA Inc., referred to generally as "Finco", filed for bankruptcy under Chapter 11 of the Bankruptcy Code. Upon the commencement of the bankruptcy cases, the debtors operated as debtors-in-possession. Shortly thereafter, on November 7, 2011, the Office of the United States Trustee formed a creditors' committee representing the unsecured creditor constituency of the Chapter 11 debtor entities. Without any possibility of rehabilitation, the debtors and the creditors committee jointly filed a motion to appoint a Chapter 11 Trustee. That motion was approved by the Court, and I was named as the Chapter 11 Trustee. My appointment was approved by the Bankruptcy Court effective as of November 28, 2011.

On December 19, 2011, three additional MF Global entities that are each indirect subsidiaries of the Chapter 11 parent filed for bankruptcy. I was subsequently appointed the Chapter 11 Trustee of those entities as well. In addition, on March 2, 2012, MF Global Holdings USA Inc., a direct subsidiary of the parent holding company debtor, filed for bankruptcy protection. On March 8, 2012, I was also appointed Chapter 11 Trustee of that estate. As is evident from this brief timeline, we are in the early stages of this bankruptcy proceeding, and there is still much information to be learned about the facts and circumstances that led to the collapse of MF Global.

My duties as a Chapter 11 Trustee are set forth in Section 1106 of the Bankruptcy Code and include the obligation to investigate the acts, conduct, assets, liabilities and financial condition of the debtor, among other things. Unlike the SIPA Trustee, who is charged primarily with the return to customers of their investment property, the responsibility of the Chapter 11 Trustee is to maximize the value of the estate for the benefit of its creditors.

Upon my appointment on November 28, 2011, I began to assemble a team of legal advisors and financial consultants with extensive experience in bankruptcy matters, as it was widely believed that these proceedings were likely to be among the most complex bankruptcy matters in recent memory. We immediately began to assess the Debtors' state of affairs. Investigations into the collapse of MF Global were already being conducted by the CME, the SEC, the CFTC, and the SIPA Trustee, and at least two Federal prosecutors' offices.. Customers of MF Global Inc., the U.S. broker dealer, had already commenced litigation against certain officers and directors of the broker dealer as well as those of the parent holding company debtor.

Even before the commencement of my appointment, the Debtors were faced with a number of expansive requests for documents and information and my team immediately immersed itself in a process that had already been unfolding for several weeks, in an effort to learn what documents were in my possession, how records were maintained, and where files were kept. All of this was critical to our ability to fulfill our obligations as Chapter 11 Trustee.

These difficulties were exacerbated by the fact that what had once been operated as one large MF Global worldwide organization suddenly became fragmented, virtually overnight. Separate proceedings were commenced for individual MF Global entities, most notably the SIPA proceeding here in the U.S. and the U.K. administration (the U.K. equivalent of a U.S. bankruptcy proceeding) of the U.K. broker dealer, which proceed independently from one another. The MF Global entities suddenly found themselves without access to global systems previously utilized by the entire group of companies, because certain entity-wide systems such as accounting and email systems were owned and controlled by individual MF Global companies.

With these difficulties, the Chapter 11 debtors had been able to assemble some materials before my appointment. I needed, however, to ascertain what documents, files, information, and materials were the property of the Chapter 11 parent, versus property of the SIPA estate, the U.K. broker dealer estate, or perhaps jointly owned by a Chapter 11 debtor and another estate. My advisory team was required to review thousands of pages of emails, documents and other files to determine (1) what those materials said, (2) whether the materials were responsive to any request by any governmental agency or the SIPA Trustee, and (3) whether any protectable corporate privilege existed. I then needed to implement a process to produce as quickly as we could documents requested as part of the investigations, but also in a manner

that did not unnecessarily result in a broad waiver of any existing privilege. To do otherwise at this very early stage potentially could have been contrary to my obligations as Chapter 11 Trustee. Ultimately, these issues were resolved and the process moved forward expeditiously.

Although none of the entities for which I serve as Chapter 11 Trustee are regulated entities, the concerns of customers are nonetheless important to me and my advisors. With a backdrop of allegations of missing customer funds, the Bankruptcy Judge, the Honorable Martin Glenn, directed that my team perform an analysis of the approximately $25 million held in a cash collateral account owned by Finco to determine whether that cash included misappropriated MF Global Inc. customer property. Thereafter, my advisors poured through account data and transaction documents covering more than $3.5 billion in cash transfers, including transfers from accounts held by MF Global Inc. My advisors interviewed and met with employees of MF Global Inc. and advisors retained by the SIPA Trustee in order to ensure that an appropriate investigation had been conducted in preparing the report. Upon completing the analysis, which was shared with the SIPA Trustee, we concluded with no disagreement from the opinion of the SIPA Trustee that the cash collateral account did not include misappropriated or misdirected customer funds.

There has been a great deal of publicity regarding the shortfall in customer property. Without in any way diminishing the importance of the SIPA Trustee's obligation to locate and recover customer property, the Bankruptcy Code requires me to attempt to recover for the benefit of the creditors of the Chapter 11 estates monies that were obtained by the parent from third party lenders and investors and routed to the U.S. broker dealer or elsewhere. In particular, and by way of example, during the month of October, 2011, in excess of $1 billion in cash was transferred from MF Global Holdings Ltd. and Finco to MF Global Inc. In addition, a substantial portion of the net proceeds from the $650 million of MF Global bonds sold in 2011 to investors by MF Global Holdings Ltd. had been transferred to MF Global Inc. Just as the SIPA Trustee is analyzing and investigating the whereabouts of funds and property entrusted by customers to the U.S. broker dealer, so too my team must investigate the whereabouts of funds loaned to the U.S. broker dealer for which the Chapter 11 estates remain liable to creditors and investors.

In furtherance of my duty to investigate the affairs of the Chapter 11 debtors for which I serve as Trustee, my advisors and I meet regularly with our creditors committee as well as with representatives of the SIPA Trustee and the representatives of the foreign affiliates. These meetings are important for each of the estates to gather and share information with one another to facilitate a timely investigation of the facts and circumstances leading up to the bankruptcy and to determine where the assets of the various estates may be located.

The representatives of the SIPA Trustee and my advisors often speak daily, have engaged in information sharing calls at least weekly, and are currently discussing coordinated efforts to assist one another in the administration of our respective estates. I have found this cooperation to be invaluable, if not essential, to my ability to satisfy my fiduciary obligations as a Chapter 11 Trustee. I strongly believe that the interests of all of the various estates are best served by cooperating and sharing information to uncover precisely what led to the collapse of MF Global. No one estate has all of the information, but together, the puzzle pieces can be put together.

To be clear, the trustees and foreign administrators can and likely will assert different legal arguments to support their claims to property located throughout the world. The bankruptcy court and perhaps other courts will make those legal determinations. But the ultimate legal disputes that may arise should not serve as a barrier to sharing the critical facts to tell the world what led to the collapse. Notwithstanding that we are operating under the supervision of the court, however, it is clear even at this early stage that the competing, and perhaps at times conflicting, obligations and duties of the two Trustees and various foreign administrators has and will continue to have the effect of extending the length of time necessary for all of the estates to conduct their investigations; to determine the value and location of assets; and ultimately to make distributions to customers and/or creditors.

At the present time, the Chapter 11 debtors employ approximately 15 nonexecutive individuals, most of whom had been employed by one of the debtors prior to the commencement of the bankruptcy cases. They, along with the remaining senior executives, continue to provide invaluable support in reconciling the debtors' books and records, closing open trades at the unregulated entities, the preparation of tax returns, and assisting in understanding the many complex prepetition transactions between and among the various MF Global entities.

In conversations about retaining these individuals and the knowledge they possess, I've discussed at various times the possibility of establishing a retention program. To be clear, no formal program was ever created for senior executives, nor

was any motion ever filed with the court for approval in connection with any retention program for senior executives.

As we continue our investigation, we will be filing a report with the Bankruptcy Court on or before June 4, 2012. Mindful of this impending deadline, we have filed with the Bankruptcy Court a motion seeking authority to issue subpoenas for the production of documents and examination of witnesses on a shortened timetable. That motion will be heard on April 25, 2012. We remain hopeful that parties will be cooperative during this investigation, but a formal process will be utilized as necessary.

It is important to note that the transparency of the bankruptcy process mandates that the work performed by the Chapter 11 Trustee is closely monitored by the Office of the United States Trustee and supervised by the United States Bankruptcy Court.

I fully intend to fulfill my legal obligations as Chapter 11 Trustee as timely and transparently as I can responsibly do so, recognizing that all of my, and my professionals, actions must be consistent with the duties and obligations set forth in the Bankruptcy Code.

PREPARED STATEMENT OF JILL E. SOMMERS

COMMISSIONER, COMMODITY FUTURES TRADING COMMISSION

APRIL 24, 2012

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 5½ 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 nonfutures 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, record keeping or financial reporting requirements.

Coordination Among Regulators for Dually Registered BD–FCMs

The Act and Commission regulations establish a regulatory structure where frontline 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 nonclearing 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 2-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.

PREPARED STATEMENT OF ROBERT COOK

DIRECTOR, DIVISION OF TRADING AND MARKETS, SECURITIES AND EXCHANGE COMMISSION

APRIL 24, 2012

Chairman Johnson, Ranking Member Shelby, Members of the Committee, my name is Robert Cook, and I am the Director of the Division of Trading and Markets at the Securities and Exchange Commission (SEC). Thank you for the opportunity to testify on behalf of the SEC concerning the collapse of MF Global.

The bankruptcy of MF Global has resulted in serious hardship for many of its customers, who have experienced significant delays and uncertainty with respect to their ability to access their own assets. More broadly, the firm's collapse and the apparent shortfall in customer assets highlight the need for financial firms and regulators to remain vigilant in ensuring that customer assets are appropriately protected and made readily available to customers whenever they may be needed.

To that end, the SEC and its staff are working with the trustee, our fellow financial regulators, and other authorities to facilitate the orderly liquidation of MF Global and the return of MF Global customer assets. While the examination and review of the causes and implications of the collapse of MF Global are ongoing, my testimony provides an overview of the regulation of MF Global's SEC-registered broker-dealer subsidiary prior to the bankruptcy, the key events leading up to the bankruptcy, the status of approximately 318 securities accounts in the liquidation proceedings, and the securities customer protection regime. My testimony also describes some implications of MF Global's bankruptcy for market oversight, as well as a summary of recent efforts by the SEC to promote sharing of information among regulators, a proposal by the SEC to further strengthen the rules that affect the protection of customer assets, and self-regulatory organization (SRO) initiatives to enhance the financial responsibility regime for broker-dealers.

Regulation of MF Global Prior to Its Bankruptcy

MF Global Holdings Ltd. (together with its subsidiaries, "MF Global") was a publicly traded holding company that conducted financial activities through a number of subsidiaries located in various countries. MF Global Inc. (MFGI), an indirect subsidiary of the holding company, was dually registered with the Commodity Futures Trading Commission (CFTC) as a futures commission merchant (FCM) and with the SEC as a broker-dealer. As of October 31, 2011, MFGI had approximately 36,000 futures customers [1] and approximately 318 custodial accounts for nonaffiliated securities customers. [2] MFGI also was authorized by the Federal Reserve Bank of New York to act as a primary dealer in the U.S. Treasury markets. Another affiliate, MF Global U.K. Limited, was regulated by the U.K. Financial Services Authority (FSA). There was no consolidated supervisor of MF Global at the holding company level.

The "frontline" supervisory function for the securities activities of broker-dealers is performed by the SROs, including the Financial Industry Regulatory Authority (FINRA) and the various securities exchanges. When a broker-dealer is a member of multiple SROs, one SRO functions as the "designated examining authority" (DEA) responsible in the first instance for examining the securities component of the firm's financial and operational programs, including its compliance with the SEC's capital and customer protection requirements. In the case of MFGI, the DEA was the Chicago Board Options Exchange (CBOE), although FINRA was also closely involved in the oversight of MFGI's broker-dealer activities. The futures activities of financial firms, including related segregation requirements, are overseen by the CFTC and the futures SROs, including the National Futures Association and the Chicago Mercantile Exchange.

The SEC oversees the regulatory functions of securities SROs and regularly communicates and coordinates with them on examinations and other matters. In its SRO role, CBOE conducted examinations of MFGI for compliance with financial responsibility rules. FINRA conducted examinations for compliance with other rules, such as sales practice requirements. In addition, the SEC's national examination program conducts its own risk-based examinations of SEC-registered broker-dealers. Unlike some other regulators of financial firms, the SEC does not have an "on site" presence at any broker-dealer and generally does not have examination staff dedicated solely to particular broker-dealers.

Key Events Leading up to the Bankruptcy

Although the investigation of the causes of MFGI's collapse is ongoing, we can highlight our current understanding of several key events leading up to its failure. [3]

Capital Treatment of Repo-to-Maturity Transactions

During 2010, MFGI started acquiring significant proprietary positions in European sovereign debt, which were financed using an instrument called a "repo-to-maturity" (RTM). [4] As of March 31, 2011, MFGI had accumulated several billion dollars of European sovereign debt positions using RTM transactions. [5]

In the summer of 2011, based on an analysis of MFGI's financial statements, FINRA and CBOE staffs questioned MFGI about whether the firm was properly rec-

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[1] *See,* "Expedited Motion to Approve Further Transactions and Distributions for MF Global Inc. United States Commodity Futures Customers" (Nov. 29, 2011).

[2] In his motion seeking authorization to sell and transfer substantially all customer securities accounts held by MFGI, the trustee identified approximately 330 securities accounts that were custodial accounts that had positive net equity on October 31, 2011, excluding accounts of affiliates and firm insiders. *See,* Motion of James W. Giddens, Trustee for the Liquidation of MF Global Inc., for an Order Authorizing the Sale, Transfer, and Assignment of Certain Customer Securities Accounts (Nov. 30, 2011) (Trustee Securities Account Transfer Motion). A subsequent status update filed by the trustee with the U.S. Bankruptcy Court for the Southern District of New York indicated that the court's order applied to the sale and transfer of "approximately 318 active retail securities accounts." *See,* Trustee's Preliminary Report on Status of his Investigation and Interim Status Report on Claims Process and Account Transfers (Feb. 6, 2012) (Trustee Interim Status Report).

[3] The events described in this testimony, other than those that are a matter of public record, are based on SEC staff's current recollection and information, including information from third parties that is currently unconfirmed. SEC staff's knowledge of the facts surrounding the bankruptcy of MF Global continues to develop, and accordingly the description of events herein is subject to change.

[4] An RTM is a form of a repurchase agreement. A repurchase agreement generally involves the sale of securities—here, European sovereign bonds—coupled with an agreement to repurchase the securities at a later date at a fixed price. In an RTM transaction, the repurchase date is the same date as the maturity date for the securities that were sold.

[5] *See,* MF Global Inc., Financial and Operational Combined Uniform Single (FOCUS) Report: Information Required of All Brokers and Dealers Pursuant to Rule 17a-5, Part III (Form X-17A-5 Part III) (Mar. 31, 2011), Statement of Financial Condition, Note 4.

ognizing its RTM positions for purposes of its regulatory net capital computations. The SEC's net capital rules (which are similar to those of the CFTC in important respects) require broker-dealers, including MFGI, to maintain certain minimum amounts of liquid capital based on their business activities. After consulting with SEC staff, SRO staff informed MFGI that under the SEC's rules it must take capital charges for the European sovereign positions as if they were on the firm's balance sheet, notwithstanding the fact that the bonds had been "sold" pursuant to the RTM transactions.

In August 2011, representatives of MFGI contacted SEC staff in Washington, DC, to request a meeting to present the firm's view that the RTM positions should be subject to lesser capital charges than those determined by staff from the SROs and SEC. On August 15, 2011, SEC staff met with representatives of MF Global, including its Chief Executive Officer, Jon S. Corzine, to discuss this issue. After further consultations among the regulators, FINRA staff informed MFGI on or around August 24 that the regulators' collective view that a capital charge was required for the RTM positions had not changed.

Following the resolution of that issue, the regulators also discussed with MFGI: (1) whether MFGI needed to provide a formal net capital deficiency notice under SEC Rule 17a-11, which generally requires broker-dealers to provide a "hindsight notice" of any deficiency in their compliance with the SEC's financial responsibility rules; and (2) whether MFGI needed to restate and refile its monthly "FOCUS" report (containing capital and certain other financial information) for July 2011, which could result in the net capital deficiency becoming public.[6] Pursuant to Rule 17a-11, once the deficiency was identified, the firm was required to file the "hindsight notice" and, on August 25, it did so. After consulting with SEC staff, SRO staff also required the firm to file an amended FOCUS report for July 2011. On August 31, MFGI amended its FOCUS report for July 2011 to reflect the required capital charges, reporting a "hindsight" capital deficiency of approximately $150 million as of July 31, 2011. At the holding company level, MF Global disclosed the net capital issue regarding the RTM positions at MFGI in an amendment to MF Global's public filings on September 1.[7]

Bankruptcy of MF Global

During the week of October 17, 2011, press reports noted that regulators had directed MF Global to increase capital at MFGI due to concerns about MFGI's capital treatment of its RTM positions. On Tuesday, October 25, 2011, MF Global announced quarterly earnings, reporting a net loss of $192 million for the three months ending September 30, 2011. Its stock price declined almost 50 percent that day and continued to decline over the week. During this same week, certain credit rating agencies downgraded the firm's credit rating or put it on negative watch. MF Global informed SEC staff during this week that certain counterparties and customers were reducing their exposures to MFGI, and MFGI was undertaking significant efforts to reduce the size of its balance sheet.

SEC staff commenced a continuous on-site presence at MFGI's New York office beginning on October 27 to monitor the firm's condition, and to engage with senior management regarding the steps that were being taken by the firm. On Friday, October 28, MF Global management reported on developments to Chairman Mary Schapiro and SEC staff, including myself. According to the firm, it was in discussions with various parties regarding potential strategic transactions, such as the sale of the firm, the sale of the RTM positions, and the sale of the firm's customer business. We continued to receive updates from our on-site staff and from calls with firm management on Saturday and Sunday, and we continued to consult closely with other regulators, including the CFTC, FINRA and the FSA. By Sunday afternoon, MF Global reported that the firm was close to concluding a strategic transaction with a potential purchaser of the customer business of MFGI, which could provide customers with continued access to their accounts. SEC staff worked closely with the CFTC and FSA to review and comment on the key transaction terms to determine that they provided adequate customer protection. However, MF Global subsequently reported in the early morning hours of Monday, October 31, that MFGI had identified a significant deficiency in its segregated accounts for futures customers, and that the acquisition negotiations had terminated.

At that point, after considering MFGI's financial condition and available alternatives, SEC staff determined, in consultation with the CFTC, that the safest and most prudent course of action to protect customer accounts and assets was to ini-

[6] FOCUS reports are filed by broker-dealers with their DEA pursuant to SEC Rule 17a-5.

[7] *See,* MF Global Holdings Ltd., Amendment No. 1 to the Quarterly Report for the Period Ended June 30, 2011 (Form 10Q/A) (Sept. 1, 2011).

tiate a liquidation proceeding under the Securities Investor Protection Act (SIPA).[8] A referral was made to the Securities Investor Protection Corporation (SIPC) early in the morning on Monday, October 31. On that same day, the U.S. District Court for the Southern District of New York entered an order granting the application of SIPC to commence a liquidation of MFGI under SIPA and appointing James W. Giddens as trustee for the liquidation. The case was then removed to the U.S. Bankruptcy Court for the Southern District of New York (Bankruptcy Court). Also on October 31, MF Global Holdings Ltd. separately filed a voluntary bankruptcy petition in the Bankruptcy Court, and MF Global U.K. Limited entered administration proceedings in the United Kingdom.

MFGI Liquidation and the Impact on Securities Customers

The preferred method of returning securities customer assets in a SIPA liquidation generally is to transfer those assets in bulk to another solvent broker-dealer. This approach typically provides customers with access to their securities and funds more quickly than the claims process. Accordingly, shortly after the initiation of the SIPA proceeding, the trustee solicited from other broker-dealers interest in taking over MFGI's securities customer accounts. Based on the available expressions of interest, on November 30, 2011, the trustee filed an expedited motion seeking authorization to sell and transfer substantially all securities custody accounts to another broker-dealer. This sale and transfer applied to approximately 318 accounts held for nonaffiliated securities customers of MFGI. The transaction was approved by the Bankruptcy Court on December 9, 2011.

Securities customers are able to trade their securities and use their funds upon completion of the transfer of their accounts. Moreover, each customer is given the option of maintaining the customer's securities account at the receiving broker-dealer or moving the account to a different broker-dealer selected by the customer. According to the trustee, of all former MFGI securities customers, nearly all have received 60 percent or more of their account value, and 194 have received the entirety of their account balances, after giving effect to the protection afforded by SIPC (up to $500,000).[9] Customers who do not ultimately receive 100 percent of their net equity through this initial transfer may be able to receive additional funds, up to the aggregate amount of their net equity, if the trustee determines that there is customer property available for that purpose. Although the claims submission deadline was January 31, 2012, for former MFGI commodities customers and former MFGI securities customers seeking the maximum protection under SIPA, securities customers and all general claimants may still submit claims to the trustee through June 2, 2012.

Throughout this process, SEC staff has been working closely with the trustee and SIPC, seeking to expedite the return of assets to customers of MFGI. To that end, SEC staff has been in frequent communication with the trustee with respect to the status of the transfers and claims made by securities customers.

Securities Customer Protection Regime

MFGI acted as a "carrying" firm for a small number of securities customers, meaning that it held their funds and securities. MFGI also had additional securities customers for which it executed purchases and sales of securities but did not hold funds and securities—rather, such securities were held at other custodians that settled transactions executed through MFGI on a "delivery versus payment" basis.

As a broker-dealer registered with the SEC, MFGI was subject to the SEC's customer protection rule. This rule requires that each broker-dealer that holds securities or cash for customers take two primary steps to safeguard customer property. These steps are designed to protect customer property by prohibiting broker-dealers from using customer funds and securities to support their proprietary positions or expenses. Together with the applicable SEC capital requirements, this regime also is meant to make it more likely that, if the broker-dealer fails, segregated securities and funds will be readily available to be returned to the customers.

The first step required under the customer protection rule is that the broker-dealer must maintain physical possession or control over securities that customers have paid for in full. This means that if a customer has fully paid for his or her securities, they cannot be used by the broker-dealer in its business—for example, they cannot be pledged as collateral to finance the firm's own trades or to raise funds for the firm to invest. Further, if a customer has a margin loan, the customer protection rule strictly limits the amount of securities that can be used by the broker-

[8] SEC–CFTC Statement on MF Global, Oct. 31, 2011, available at *http://sec.gov/news/press/2011/2011-230.htm.*

[9] *See,* Trustee Interim Status Report, *supra* note 2.

dealer for financing purposes. The goal in both cases is to require broker-dealers to hold customer securities in a manner that allows those securities to be readily available to customers, either on demand or upon the liquidation of the firm.

The second step required under the customer protection rule is that the broker-dealer must maintain a reserve in an account at a bank for the benefit of customers in an amount that exceeds the net funds attributable to customer positions. These funds cannot be invested in any instrument that is not guaranteed, as to principal and interest, by the full faith and credit of the U.S. Government. The amount owed to customers must be computed pursuant to a prescribed formula, normally on a weekly basis. A broker-dealer cannot make a withdrawal from the reserve account until the next computation, and then only if the computation indicates that there is an excess amount in reserve—greater than what is required to be maintained under the rule. In essence, this requirement complements the protection afforded to securities held at a broker-dealer by requiring the firm to maintain a reserve of funds or U.S. Government guaranteed securities equal to its net cash obligations attributable to customer positions.

A broker-dealer that complies with the customer protection rule—isolating customer funds and securities through these steps and separating them from the firm's proprietary business—should be in a position to return all the securities and funds it owes to customers if it falls into financial difficulty. If a broker-dealer cannot return all the securities and funds owed to customers, SIPC has the responsibility to institute a proceeding under SIPA to liquidate the broker-dealer. Under SIPA, all securities customers share *pro rata* in the available securities customer property before any other types of creditors of the broker-dealer. If the available securities customer property is insufficient to return 100 percent of the amount owed to securities customers, SIPC may advance up to $500,000 per customer (of which $250,000 can be used to make up a cash shortfall).

Implications for Market Oversight

While our near term focus has been on working with SIPC and the trustee to facilitate the return of securities and funds to customers of MFGI, the SEC will continue to strive to identify further enhancements to its customer protection regime that may be appropriate.

The events leading up to the bankruptcy of MF Global and its aftermath reinforce the importance of close and ongoing coordination and information sharing among regulators and other interested parties. In this case, these parties included not only the SEC and CFTC and other Federal regulators, but also the SROs, the FSA, SIPC, and, following the bankruptcy filing, the trustee.

Protection of Customer Assets

While our experience with addressing MF Global's failure highlights the importance of domestic and international regulatory coordination, it also underscores the paramount importance of the rules governing protection of customer assets and the controls that are crucial for compliance with those rules. In general, the rules governing protection of customer funds and securities that apply to registered broker-dealers, described above, have worked well over time, but we are considering whether there are ways that they could be strengthened. In particular, in June 2011, the SEC proposed rule changes that are meant to clarify and strengthen the rules governing audits of broker-dealers, including an auditor's examination of broker-dealer controls relating to the custody of customer assets, as well as to enhance the SEC's oversight of broker-dealers that hold customer securities and funds. Specifically, the proposal would:

- Enhance the current requirement that a broker-dealer undergo an annual audit by a public accounting firm registered with the Public Company Accounting Oversight Board by strengthening the standards that govern the auditor's examination of the broker-dealer's compliance, and internal controls over compliance, with SEC net capital and custody requirements.
- Require that broker-dealers that maintain custody of customer assets file with the SEC a new "Form Custody" every quarter. This form would contain more detailed information about how broker-dealers maintain custody of customer assets in order to further facilitate verification by examiners that customer assets are being properly protected.

SEC staff has evaluated comments received in response to this proposal and is working to finalize a recommendation to the Commission.

More broadly, the staff is evaluating other possible rule changes to the financial responsibility requirements, including some previously considered by the Commission that could strengthen customer protection. For example, one change under con-

sideration would be to limit, for purposes of the customer reserve fund required by Rule 15c3-3, the amount of cash a broker-dealer could maintain in any one bank, as a percentage of capital of the broker-dealer or the bank.

The SEC also continues to work with the SROs to help strengthen broker-dealer financial responsibility requirements. For example, in June 2011, the SEC approved a FINRA rule filing to establish registration, qualification, examination, and continuing education requirements for certain operations—or "back office"—personnel, including those who handle customer assets. This rule should help to better ensure that those responsible for operations functions are fully versed in all the relevant rules and their obligations, including those relating to the segregation and protection of customer assets. In addition, in February 2012, the SEC approved a FINRA proposal to require each member firm to file certain additional financial or operational schedules or reports to supplement existing requirements to file FOCUS reports with FINRA pursuant to SEC Rule 17a-5. This rule allows FINRA to receive more granular data pertinent to income and expense items, and therefore to better identify firms that warrant heightened scrutiny and to evaluate industry-wide trends.

In February of this year, the SIPC Modernization Task Force, which was established by SIPC for the purpose of undertaking a comprehensive review of its operations and policies and to propose reforms to modernize SIPA and SIPC, issued a number of recommendations, including proposed statutory changes. SEC staff is evaluating these recommendations, several of which are directed to the scope and dollar limit of protection for individual customers in SIPC liquidations. Although SIPC has not itself yet responded to the recommendations, we look forward to discussing them with SIPC as part of our review.

Finally, with regard to accounting standards, in March 2012, the Chairman of the Financial Accounting Standards Board (FASB) added a project to the FASB's agenda to reconsider the accounting and disclosure requirements for repurchase agreements and similar transactions. The FASB Chairman cited the need to revisit the accounting requirements to address application issues as a result of changes in the marketplace and to ensure that investors obtain useful information about these transactions. As part of the project, the FASB is expected to reconsider the accounting and disclosures requirements related to RTM transactions. There is ongoing communication between SEC staff and the FASB regarding their standard-setting efforts.

Regulatory Cooperation

Given the pace of developments in the financial markets generally and, in particular, how quickly the financial condition of a financial firm that is in distress can deteriorate, the SEC is engaged in a number of efforts—both domestic and international—to share more and better data and qualitative assessments of firms and markets, and to do so in a timely way. Some of these efforts involve coordination with the SROs, in recognition of their importance as "frontline" supervisors.

For example, examination staff in the SEC's Office of Compliance Inspections and Examinations (OCIE) recently initiated quarterly meetings with FINRA and CBOE and semi-annual meetings with the Chicago Stock Exchange (CHX), in each case in respect of the SRO's capacity as a DEA. Further, OCIE recently has sought to enhance its inter-regulator Summit of Securities Regulators, increasing the frequency with which it convenes and expanding the group of regulators such that it now includes FINRA, CBOE, CHX, the Municipal Securities Rulemaking Board, the North American Securities Administrators Association, the Federal Reserve Board, various Federal Reserve Banks, and the CFTC. The first meeting of the expanded group will take place this month and will provide an opportunity for this diverse gathering of regulators to discuss issues and concerns regarding registrants, current regulatory developments, and to identify common risks and collaboration opportunities. In addition to these recent initiatives, the Commission has been a key participant in the Intermarket Surveillance Group (ISG) since its formation in the 1980s. The ISG provides a critical venue for sharing investigative information and surveillance data among domestic and foreign market centers, market regulators, and exchanges, including both securities and futures exchanges.

For many years, the SEC has been engaged in numerous and ongoing efforts to increase cooperation and the flow of information relevant to market oversight among international regulators, through various means, including cooperative arrangements, such as memoranda of understanding (MOU), informal and formal bilateral discussions, and participation in multilateral organizations. [10]

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[10] A list of supervisory MOUs is available at: *http://www.sec.gov/about/offices/oia/oia_cooparrangements.shtml.*

In the international sphere, the SEC works closely with both banking and securities regulators through various venues, including the Financial Stability Board, IOSCO, the Council of Securities Regulators of the Americas, the Cross-border Crisis Management Working Group, and the Senior Supervisors Group. The SEC also has ongoing bilateral dialogues with key international regulatory counterparts, including the United Kingdom, India, China, Korea, and Turkey. Furthermore, the SEC participates alongside the Department of the Treasury and the Federal Reserve Board in the Financial Markets Regulatory Dialogue with the European Union.

Conclusion

The SEC and its staff are working with our fellow financial regulators and other authorities to facilitate the identification and return of customer assets. We also are engaged in ongoing efforts to increase the exchange among regulators of information that is relevant to oversight of markets and market intermediaries, and are considering measures to further strengthen the existing customer protection regime.

I would be pleased to answer any questions you may have.

PREPARED STATEMENT OF RICHARD G. KETCHUM

CHAIRMAN AND CHIEF EXECUTIVE OFFICER, FINANCIAL INDUSTRY REGULATORY AUTHORITY

APRIL 24, 2012

Chairman Johnson, Ranking Member Shelby, and Members of the Committee, I am Richard Ketchum, Chairman and CEO of the Financial Industry Regulatory Authority, or FINRA. On behalf of FINRA, I would like to thank you for the opportunity to testify today.

When a firm like MF Global fails, there is always value in reviewing the events leading to that failure and examining where rules and processes might be improved. I commend the Committee for having this hearing to do just that. Clearly the continued impact of MF Global's failure on customers who cannot access their funds is of great concern, and every possible step should be taken to restore those accounts as quickly as possible.

Like many other financial firms today, MF Global's operations included multiple business lines, engaging multiple regulatory schemes and crossing national boundaries. We and the other regulators here today will explain our roles in overseeing the various parts of the firm. We all share the goal of restoring funds to customers. While FINRA's role in that process is limited at this stage, we are committed to continuing to provide assistance wherever we can.

FINRA

FINRA is the largest independent regulator for all securities firms doing business in the United States, and, through its comprehensive regulatory oversight programs, regulates both the firms and professionals that sell securities in the United States and the U.S. securities markets. FINRA oversees approximately 4,500 brokerage firms, 163,000 branch offices and 630,000 registered securities representatives. FINRA touches virtually every aspect of the securities business—from registering industry participants to examining securities firms; writing rules and enforcing those rules and the Federal securities laws; informing and educating the investing public; providing trade reporting and other industry utilities and administering the largest dispute resolution forum for investors and registered firms.

In 2011, FINRA brought 1,488 disciplinary actions, collected fines totaling more than $63 million and ordered the payment of almost $19 million in restitution to harmed investors. FINRA expelled 21 firms from the securities industry, barred 329 individuals and suspended 475 from association with FINRA-regulated firms. Last year, FINRA conducted approximately 2,400 cycle examinations and nearly 6,800 cause examinations.

One of our regulatory programs that is particularly relevant to today's hearing is our financial and operational surveillance. Through this program, FINRA reviews FOCUS (Financial and Operational Combined Uniform Single) reports that broker-dealers file on a monthly basis as required by the Securities and Exchange Commission (SEC). These reports detail a firm's financial and operational conditions and allow FINRA to closely monitor a firm's net capital position and profitability for signs of potential problems.

FINRA's activities are overseen by the SEC, which approves all FINRA rules and has oversight authority over FINRA operations.

Oversight of MF Global

Like many financial firms today that operate simultaneously in multiple channels, MF Global was not solely a broker-dealer, but also a futures commission merchant or FCM. As such, multiple Government regulators and self-regulatory organizations (SROs), including FINRA, had a role in overseeing various parts of the firm's operations.

With respect to oversight of MF Global's financial and operational compliance, which is most relevant to today's hearing, FINRA shared oversight responsibilities with the Chicago Board Options Exchange (CBOE) and the SEC, especially in terms of the firm's compliance with the net capital rule. For broker-dealers that are members of multiple SROs, the SEC assigns a Designated Examining Authority, or DEA, to examine the firm's financial and operational programs, including the firm's compliance with the Commission's net capital and customer protection rules. For MF Global, that DEA was the CBOE. As such, CBOE conducted the regular examinations of the firm for capital compliance.

There are two primary SEC rules for which financial examinations evaluate compliance, the net capital and customer protection rules. The primary purpose of the SEC's net capital rule, 15c3-1, is to protect customers and creditors of a registered broker-dealer from monetary losses and delays that can occur if that broker-dealer fails. It requires firms to maintain sufficient liquid assets to satisfy customer and creditor claims. It accomplishes this by requiring brokerage firms to maintain net capital in excess of certain minimum amounts. A firm's net capital takes into account net worth, reduced by illiquid assets and various deductions to account for market and credit risk. This amount is measured against the minimum amount of net capital a firm is required to maintain, which depends on its size and business. The net capital rule is intended to provide an extra buffer of protection, beyond rules requiring segregation of customer funds, so that if a firm cannot continue business and needs to liquidate, resources will be available for them to do so.

The SEC's customer protection rule, 15c3-3, has two components, reserve formula computation and possession or control, and was designed to ensure the safety of customers' assets. The objective of the reserve formula computation is to protect the customer funds in the event the broker-dealer becomes financially insolvent. Possession or control requires that the broker-dealer obtain prompt possession or control of customers' fully paid for and excess margin securities, ensure that customers' assets held by a broker-dealer are properly safeguarded against unauthorized use and separate firm and customer related business.

Fewer than 20 FINRA-regulated broker-dealers have a DEA other than FINRA, but in those cases, we work closely and cooperatively with the DEA when questions or issues arise. Even when we are not the DEA for one of our regulated broker-dealers, FINRA monitors and analyzes the firm's FOCUS report filings and annual audited financial statements as part of our ongoing oversight of the firm. That was the case with MF Global.

While that monitoring focuses on a broad range of issues, it is particularly relevant to note that our financial surveillance team placed a heightened focus on exposure to European sovereign debt beginning in spring 2010. During April and May, our staff began surveying firms as to their positions in European sovereign debt as part of our ongoing monitoring of regulated firms.

In response to our outreach on this issue, MF Global indicated in late September 2010 that the firm did not have any such positions. We later learned that the firm began entering into transactions that carried European debt exposure prior to that inquiry. While the firm's response was consistent with GAAP accounting rules that repo-to-maturity (RTM) transactions are treated as a sale for accounting purposes, the lack of a complete response delayed us in detecting the firm's exposure.

MF Global's Exposure to European Sovereign Debt

In a routine review of MF Global's audited financial statements filed with FINRA on May 31, 2011, our staff raised questions about a footnote disclosure regarding the firm's RTM portfolio. RTMs are essentially transactions whereby the maturity date of a firm's bond position held in its inventory matches the maturity date of the repo. During the course of discussions with the firm, FINRA learned that a significant portion of that portfolio was collateralized by approximately $7.6 billion in European sovereign debt. According to U.S. GAAP, RTMs are afforded sale treatment and therefore not recognized on the balance sheet. Notwithstanding that accounting position, the firm remained subject to market and credit risk throughout the life of the repo.

Beginning in mid-June, FINRA had detailed discussions with the firm, in which CBOE also participated, regarding the proper treatment of the RTM portfolio and we asserted that not enough capital was reserved against the RTM. While the SEC

has issued guidance clarifying that RTMs collateralized by U.S. Treasury debt do not require capital to be reserved, there is no such relief for RTMs collateralized by debt of non-U.S. Governments. We researched whether the firm retained default risk on the positions, and concluded that it did. Our view was that while recording the RTMs as sales was consistent with GAAP, they should not be treated as such for purposes of the capital rule given the market and credit risk those positions carried. As a result, we asserted that capital needed to be reserved against the RTM.

FINRA and CBOE also had discussions with the SEC about our concerns that the firm was not holding capital against its RTM portfolio. The SEC agreed with our assertion that the firm should be holding capital against the positions. The firm fought this interpretation throughout the summer, appealing directly to the SEC, before eventually conceding in late August 2011.

The firm infused additional capital and filed an amended July FOCUS report on August 31 to report a $150 million capital deficiency in July. The firm also provided notification, pursuant to SEC Rule 17a-11, of its capital deficiency to the SEC, CBOE and FINRA as well as to the Commodity Futures Trading Commission (CFTC), pursuant to CFTC Rule 1.12. The net capital deficiency in the amended July FOCUS report was reported on the CFTC's Web site. In addition, on September 1, the firm amended its Form 10-Q filing with the SEC to identify the change in net capital treatment of the RTM portfolio.

In September, FINRA added MF Global to "alert reporting," a heightened monitoring process whereby we require firms to provide weekly information on net capital, inventory, profit and loss as well as reserve formula computations.

On October 19, the Intermarket Financial Surveillance Group (IFSG), which is comprised of securities and futures regulators and self-regulatory organizations, had its annual meeting. The IFSG was established in 1989 in order to enhance the coordination and monitoring efforts of both securities and commodities regulators. Through an information sharing agreement, SROs provide each other with financial surveillance data and related information on an as-needed basis. In addition, SRO representatives meet annually to discuss relevant capital and customer protection issues. Exposure to European sovereign debt was one of the topics at the October meeting and FINRA raised MF Global's positions during the discussions.

During the week of October 24, as MF Global's equity price declined and its credit rating was cut, FINRA increased the level of surveillance over the firm. We requested detailed information about the firm's balance sheet and liquidity; we received updates about the loss of lending counterparties and customers; and we spoke to clearing organizations about the margin required to settle trades. At the end of that week, FINRA was on site at the firm, with the SEC, as it became clear that MF Global was unlikely to continue to be a viable standalone business. Our primary goal was to gain an understanding of the custodial locations for customer securities and to work closely with potential acquirers in hopes of avoiding SIPC liquidation. As has been widely reported, the discrepancy discovered in the segregated funds on the futures side of the firm ended those discussions.

MF Global Bankruptcy and Liquidation Proceeding

On October 31, 2011, MF Global Holdings, Ltd. and MF Global, Inc. filed for bankruptcy and entered into SIPC liquidation. Since that time, FINRA has provided assistance as requested by the SEC and the trustee.

On November 4, 2011, FINRA assisted the trustee in alerting broker-dealer firms via email that the trustee was accepting proposals for the transfer of approximately 450 customer securities accounts of MF Global to another member of SIPC.

We have also assisted the trustee by providing information about other broker-dealers to which MF Global securities customer accounts may be transferred.

Increased Regulatory Coordination and New Rulemaking Efforts to Better Protect Customers and Their Funds

Both prior to and since the failure of MF Global, FINRA has worked to identify changes that can be made to better protect customers and their funds, through both our own rulemaking process, and also in terms of our coordination with our regulatory counterparts. I will highlight a few of the efforts that FINRA has been involved in over the past several months.

First, FINRA and the Chicago Mercantile Exchange have established regular coordination calls so that our respective staffs can share information about the approximately 50 firms that are both broker-dealers and futures commission merchants, and therefore are subject to the oversight of both entities. Through these calls, our staffs will have regular opportunities to discuss routine oversight issues as well as to highlight for one another any concerns or situations that warrant heightened monitoring. The goal for these calls is to enhance coordination between

our organizations and ensure that each is aware of issues identified by the other, as early as possible. In addition, FINRA is currently in discussions with the CFTC regarding possible information sharing arrangements that could further enhance oversight of dual broker-dealer/futures commission merchant firms.

Another example of enhanced coordination among regulators is a series of "supervisory colleges" that we initiated last fall. Based on the model that international regulators have used in overseeing large global banking institutions, we hosted an in-depth briefing on select nonbank investment firms and invited staff from both domestic and international regulators of securities and futures to participate. During the event, regulators were able to exchange information and engage in a dialogue with the firms' senior executive management—and each other—to gain a more comprehensive understanding of each institution's business strategy, legal and regulatory structure, corporate governance, and risk drivers. We plan to host a second such event in June and have expanded the list of regulators and SROs included in the event.

In addition to coordinating with other regulators, FINRA has continued its work on two rulemaking efforts that are aimed at enhancing financial surveillance and expediting the return of customer funds and securities in the event of liquidation.

In late February, FINRA implemented a new rule that requires FINRA-regulated firms to file additional financial or operational schedules or reports as we deem necessary to supplement the FOCUS report. The rule provides FINRA with the framework to request more specific information that we determine is necessary or appropriate for the protection of investors or in the public interest. Under this rule, the SEC has approved the adoption of one such report—the Supplemental Statement of Income—which enables FINRA to capture more granular detail about a firm's revenue and expenses, including a breakdown of commission revenues by product, a breakdown of principal trading gains and losses by security type as well as detailed components of fee and interest revenues among other things.

Also pursuant to this rule, last week, the FINRA Board approved a proposal to adopt a second supplemental FOCUS report to capture information that is not otherwise reported on certain firms' balance sheets. If approved by the SEC, all carrying and clearing firms would be required to file this information with FINRA on a quarterly basis. Captured in this report would be, among other data, gross exposures in financing transactions, such as reverse repos, repos, repos to maturity and other transactions that are otherwise netted under GAAP. This additional information will permit FINRA to more effectively assess on an ongoing basis the potential impact that off-balance sheet activities may have on such firms' net capital, leverage and liquidity, and their ability to fulfill their customer protection obligations.

FINRA has also proposed a new rule that would expedite the liquidation of a firm and most importantly, the transfer of customer assets, should a firm need to cease operations. FINRA is currently reviewing comments submitted on this proposal and will make adjustments as warranted before submitting a final proposal to the SEC for review.

Conclusion

FINRA will continue to work with our fellow regulators and Congress as the liquidation process for MF Global proceeds, and as we implement the measures identified to date which could improve oversight of similar firms and coordination between regulators. We share your commitment to reviewing the events involved in the firm's collapse, relevant rules and coordination with other regulators to continue to identify potential policy or procedural adjustments that may be warranted.

We realize that it is critical to continually evaluate the customer protection regime to ensure that it is designed as well as it can be to ensure prompt restoration of customer funds in the event of a firm collapse. To that end, we would be glad to participate in a broader review, in coordination with the SEC, CFTC, self-regulatory organizations and others to provide an overall assessment of where current rules and processes may need enhancements.

Again, I appreciate the opportunity to testify today. I would be happy to answer any questions you may have.

PREPARED STATEMENT OF TERRENCE A. DUFFY

EXECUTIVE CHAIRMAN, CME GROUP INC.

APRIL 24, 2012

Chairman Johnson, Senator Shelby, Members of the Committee, thank you for the opportunity to testify respecting some lessons learned from the collapse of futures commission merchant (FCM) and broker-dealer (BD) MF Global, Inc. (MFG) and

possible policy responses to protect customers. I am Terry Duffy, Executive Chairman of CME Group (CME Group or CME), which is the world's largest and most diverse derivatives marketplace. CME Group includes four separate exchanges—Chicago Mercantile Exchange Inc. the Board of Trade of the City of Chicago, Inc., the New York Mercantile Exchange, Inc. and the Commodity Exchange, Inc. (together "CME Group Exchanges"). The CME Group Exchanges offer the widest range of benchmark products available across all major asset classes, including futures and options based on interest rates, equity indexes, foreign exchange, energy, metals, agricultural commodities, and alternative investment products. CME also includes CME Clearing, a derivatives clearing organization and one of the largest central counterparty clearing services in the world; it provides clearing and settlement services for exchange-traded contracts, as well as for over-the-counter (OTC) derivatives transactions through CME Clearing and CME ClearPort®.

I have previously testified respecting MF Global's misuse of segregated customer funds and CME Group's efforts on behalf of customers. Today, I will summarize CME Group's and the industry's efforts to restore customer confidence, and our suggestions for strengthening customer protection and confidence going forward. I will also explain why the current system of front line auditing and regulation by clearing houses and exchanges should not be abandoned as a result of the misconduct of MF Global, and why you can be confident in the robust regulation that the SRO system provides.

Introduction

On October 31, the Securities Investor Protection Corporation (SIPC) filed a petition with a Federal District Court in New York to place MFG into bankruptcy. Unlike in prior bankruptcies of CME member firms, our clearing house was unable to transfer all customer positions and property to another firm due to missing customer funds in segregated customer accounts under the control of the FCM. Indeed, this may be the first time in the industry's history that public customer will suffer ultimate losses with respect to their accounts for U.S. futures exchange trading. [1]

The shortfall in customer segregated funds occurred only in regard to funds under MFG's control. The customers' funds held in segregation at the clearing level at CME and other U.S. clearinghouses were intact. However, the clearinghouses were not able to avoid market disruptions by immediately transferring those customer positions and any related collateral because of limitations under the Bankruptcy Code. We believe that Congress can help protect customers whose collateral is safeguarded at clearing houses by changing the bankruptcy code to permit a clearing house that holds full collateral for a failed clearing member's customers to immediately transfer customer positions, along with the required collateral for those positions, to other clearing members.

The industry is united in its search for solutions that will restore confidence in the safety of funds invested in regulated futures and derivatives markets. Obviously, changes in the Bankruptcy Code are not the only answer, and it is constructive to look at a wide range of changes that can be implemented without legislation. In order to evaluate the proposals, it is necessary to begin with an understanding of the current system for protecting customer property and positions. A bit of background information regarding the clearing model in the futures industry, including the role and obligations of FCMs and derivatives clearing houses is my starting point.

The Futures Commission Merchant

An FCM is an individual or organization that (i) solicits or accepts orders to buy or sell futures contracts or options on futures contracts and (ii) accepts money or other assets from customers to support such orders. As such, FCMs are agents or intermediaries for their customers. Among other things, the Commodity Exchange Act (CEA), which is the main statute governing the FCM's legal obligations, expressly states that all money and other property of any customer received to margin or guarantee a derivative contract cleared though a derivatives clearing organization belongs to the customer and may not be commingled with the FCM's own trading accounts.

With respect to ensuring that such customer collateral received by the FCM is segregated, the CEA, applicable regulations of the Commodity Futures Trading

[1] As recent examples, in both *Refco* and *Lehman,* which had large FCM operations, while non-futures customers were significantly impacted by the bankruptcy proceedings, the regulated commodity customer accounts were transferred to new FCMs without any disruption. We had no reason to believe this situation would be any different at MFG until the segregation shortfall at MFG was discovered.

Commission (CFTC) and our clearing house rules require that money and other customer property must be separately accounted for and may not be commingled with the funds of the FCM or be used to margin, secure, or guarantee any trades or contracts of any person other than the person for whom the same are held. Additionally, CME Clearing has rules on its books directly addressing FCMs' obligations in this regard.

In practice, an FCM maintains a number of customer segregated accounts at custodians approved by the CFTC. As a customer establishes positions, the FCM transfers collateral from one of its customer segregated accounts to a customer segregated account maintained and controlled by the clearing house. In many cases, the FCM collects margin from its customers in excess of what is required by the clearing house to support the customer positions cleared through the clearing house; this "excess margin" is often held in the customer segregated accounts controlled by the FCM. The FCM also typically holds some of its own funds in the customer segregated accounts, in order to ensure that the accounts never fall below the required segregated amount. All assets in the customer segregated accounts are subject to various CFTC and clearing house rules, including limitations on permissible investment of these funds under CFTC Regulation 1.25. Different rules apply to the assets of customers who also trade on foreign exchanges.

Derivatives Clearing Houses

A clearing house acts as the seller to every buyer and buyer to every seller of every cleared contract. For futures contracts, it pays winners and collects from losers twice each day so that debt is eliminated from the system and systemic risk is minimized. When a firm fails to pay its losses, the clearing house must still pay the other firms that have profitable positions opposite the failed firm's trades. The Guaranty Fund is one of the principal means to make such payments possible.

Each clearing member contributes assets and agrees to pay an assessment, based on its risk profile, for the sole purpose of covering any loss suffered by the clearing house when it makes good on its commitment to honor its contracts despite the default of another clearing member. This guaranty is designed to protect against the systemic risk that could arise if the default of one clearing member were to lead to the failure of other clearing members. It is worth noting that the assets in and committed to the Guaranty Fund do not belong to CME Group, they belong to the clearing members who have contributed them.

Nearly 65 different U.S. FCMs hold approximately $155 billion in U.S. customer collateral and nearly $40 billion in collateral held for trading on foreign exchanges—much of which is not placed with regulated clearing houses. As of March 2011, the total amount of customer funds held by the top 30 FCMs was more than $163 billion. No clearing house, however large, could effectively or economically guarantee all such funds and all such activity. Some have suggested that a Government insurance program similar to the equities markets' SIPC be established for futures markets. SIPC is designed to protect retail brokerage accounts up to $500,000, so even under SIPC, many larger securities accounts are not insured. While there are some smaller retail futures customers, many futures customers carry tens of millions or even more in their FCM accounts. The futures markets are mostly professional markets with very different risk profiles from the securities markets. Given the size and scope of the majority of the accounts in this business, a Government insurance scheme may be a cost prohibitive and/or ineffective solution. Nevertheless, an insurance scheme is certainly an idea that should be explored, and CME will work closely with regulators and industry participants to find solutions that can help prevent a repeat episode of such magnitude and retain, or in some cases restore, the confidence of market users.

Industry Proposals To Protect Customers

On March 12th, a special committee composed of representatives from the futures industry's regulatory organizations, including CME, offered four recommendations to strengthen current safeguards for customer segregated funds held at the firm level. CME Group is already implementing these proposals, which will include:

- Requiring all Futures Commission Merchants (FCM) to file daily segregation reports.
- Performing more frequent periodic spot checks to monitor FCM compliance with segregation requirements.
- Requiring a principal of the FCM to approve any disbursement of customer segregated funds not made for the benefit of customers and that exceeds 25 percent of the firm's excess segregated funds.

- Requiring all FCMs to file bimonthly Segregation Investment Detail Reports, reflecting how customer segregated funds are invested and where those funds are held.

In addition, in order to enhance intra-regulator coordination, we have recently established routine communications with FINRA for all of our common firms—the firm coordinators/relationship managers will reach out to each other to have these communications. We believe this will allow the coordinators on both sides to get to know one another better and to increase the sharing of information.

On February 29th, the Futures Industry Association proposed initial recommendations for enhancing the protection of customer funds. *http://www.futuresindustry.org/downloads/Initial__Recommendations__for__Customer__Funds__Protection.pdf* The specific recommendations include:

- Establishing a reporting requirement for the daily computation made by each FCM of customer funds on deposit in segregated accounts;
- Requiring FCMs to file twice-monthly reports on the investment of customer funds;
- Requiring FCMs to assure the appropriate separation of duties among individuals working at FCMs who are responsible for compliance with the rules protecting customer funds; Requiring FCMs to document their policies and procedures in several critical areas, including the valuation of securities held in segregated accounts, the selection of banks, custodians and other depositories for customer funds, and the maintenance and withdrawal of "residual interest," which consists of the excess funds deposited by firms in the customer segregated accounts.

CME has also challenged the industry and the Commission to consider whether other solutions will better serve the interests of customers and the industry. In addition to the proposed amendment of the Bankruptcy Code, CME is working with its clearing members and certain customers to find a structure that will protect their collateral against fellow customer and fraud risks. We are committed to finding a solution that will provide stronger protection for futures and swaps customers' segregated funds, from a legal, operational, and cost-benefit perspective without destroying the industry's business model.

In addition to these regulatory initiatives, we also recently launched the CME Group Family Farmer and Rancher Protection Fund to protect family farmers, family ranchers and their cooperatives against losses of up to $25,000 per participant in the event of shortfalls in segregated funds. Farming and ranching cooperatives also will be eligible for up to $100,000 per cooperative.

These steps, we hope, will help to rebuild the confidence in U.S. futures markets that was so badly shaken by the actions and failure of MF Global. While we think these initiatives are important to rebuilding that confidence, the misconduct of MF Global should not serve as a reason to undermine the current system of front line auditing and regulation by clearing houses and exchanges.

"Self-Regulation" Is a Misnomer: Both the CFTC and Clearing Houses Play Key Regulatory Roles

Some critics suggest that the current regulatory framework is somehow to blame for MF Global's misconduct. As further detailed in the discussion below, "self-regulation" in the context of futures markets regulation is a misnomer, because the regulatory structure of the modern U.S. futures industry is in fact a comprehensive network of regulatory organizations that work together to ensure the effective regulation of all industry participants.

The CEA establishes the Federal statutory framework that regulates the trading and clearing of futures and futures options in the United States, and following the recent passage of the Dodd-Frank Wall Street Reform and Consumer Protection Act, its scope has been expanded to include the over-the-counter swaps market as well. The CEA is administered by the CFTC, which establishes regulations governing the conduct and responsibilities of market participants, exchanges and clearing houses.

CME was the designated self-regulatory organization (DSRO) for MFG. As MFG's DSRO, CME was responsible for conducting periodic audits of MFG's FCM-arm and worked with the other regulatory bodies of which the firm is a member. CME conducted audits of MFG pursuant to standards and procedures established by the Joint Audit Committee (JAC)[2] and reported such results to the CFTC.

[2] The JAC is a representative committee of U.S. futures exchanges and regulatory organizations which participate in a joint audit and financial surveillance program that has been ap-

Continued

CME conducted audits of MFG, and all firms for which it was the DSRO, at least once every 9–15 months. The last audit of MFG was based on the firm's records for the close of business on January 31, 2011. This regulatory audit began subsequent to this audit date, and the audit was completed with a report date of August 4, 2011.

Some critics have suggested that the failure of MFG demonstrates that the current system of front line auditing and regulation by clearing houses and exchanges is deficient because of conflicts of interest. However, there is no conflict of interest between the CME Group's duties as a DRSO and its duties to its shareholders—both require that it diligently keep its markets fair and open by vigorously regulating all market participants.

Federal law mandates an organizational structure that eliminates conflicts of interest. In addition, we have very compelling incentives to ensure that our regulatory programs operate effectively. We have established a robust set of safeguards designed to ensure these functions operate free from conflicts of interest or inappropriate influence. The CFTC conducts its own surveillance of the markets and market participants and actively enforces compliance with the CEA and Commission regulations. In addition to the CFTC's oversight of the markets, exchanges separately establish and enforce rules governing the activity of all market participants in their markets. Further, the National Futures Association (NFA), the registered futures association for the industry, establishes rules and has regulatory authority with respect to every firm and individual who conducts futures trading business with public customers. The CFTC, in turn, oversees the effectiveness of the exchanges, clearing houses and the NFA in fulfilling their respective regulatory responsibilities.

The futures industry is a very highly regulated industry with several layers of oversight. The industry's current regulatory structure is not that of a single entity governed by its members regulating its members, but rather a structure in which exchanges, most of which are public companies, regulate the activity of all participants in their markets—members as well as nonmembers—complemented with further oversight by the NFA and CFTC.

CME Group Regulation

As discussed above, no one has a greater interest than CME Group in ensuring that its industry-leading markets are perceived as—and in fact are—safe, open and fair. CME Group does so by vigorously regulating the users of our markets. There is substantial evidence that such private regulation has served the markets and market participants very well. We have established a robust set of safeguards designed to ensure these functions operate free from conflicts of interest or inappropriate influence:

- Our ability to attract and retain business fundamentally depends on our customers' confidence in the integrity of our markets, and exceeding our customers' expectations in that regard is one of the cornerstones of our business model. Ensuring that our markets are defined by effective and appropriately balanced regulation is a competitive advantage that draws institutional, commercial and individual customers to CME Group.
- As a public company, it is only by performing our regulatory functions well that we avoid the severe reputational repercussions and associated impacts to shareholder value that would arise if lax regulation or improper conflicts were to compromise our commitment to fair, transparent and financially sound markets.
- CME Group's own capital is first at risk if a failed clearing firm's capital and collateral posted to CME is insufficient to cover a default at the clearing house, giving us the strongest possible economic incentive to ensure robust oversight of our clearing firms' compliance with our rules and CFTC regulations.
- In addition to strong economic and reputational self-interest, CME Group is subject to robust regulatory oversight, as further detailed in the next section, creating powerful regulatory incentives for CME Group to effectively regulate its markets.

The MF Global Bankruptcy

The MF Global bankruptcy was not a failure of exchange or Government-sponsored regulation. Our Audit and other regulatory teams performed their responsibilities in regard to MF Global consistent with the highest professional standards. One

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proved and is overseen by the CFTC. The purpose of the joint program is to coordinate among the participants numerous audit and financial surveillance procedures over registered futures industry entities.

hundred percent of the customer segregated collateral posted to CME and held at the clearing level, amounting to $2.5 billion, was fully accounted for. The well-publicized shortfall in U.S. customer segregated funds came from funds held at the FCM level, not funds held at the clearing level.

MF Global's unlawful transfers of customer segregated funds were a very serious violation of the CEA and exchange rules. Unfortunately, no regulator, whether an exchange sponsored regulator or otherwise, can always detect and stop an individual who is intent on breaking the law. Regulators can seek to establish appropriate rules, monitor compliance with the rules to deter misconduct and correct infractions, and in cases where a rule is broken, deter future misconduct by taking vigorous action against persons liable for breaches of the rules.

Nor were there was no conflict of interest with respect to CME Group's regulation of MF Global. Indeed, in 2008 and 2009, CME Group fined MF Global $400,000 and $495,000, respectively, for supervision failures and other violations of trading practices rules, clearly indicating that CME Group's regulators actively monitored and enforced compliance with the rules by MF Global, just as we do with every other market participant.

Notwithstanding the fact that MF Global's misconduct was the cause of the shortfall in customer segregated funds, CME Group's efforts in the wake of these events speak to the level of our commitment to ensuring our customers' confidence in our markets:

- We made an unprecedented guarantee of $550 million to the SIPC Trustee in order to accelerate the distribution of funds to customers.
- CME Trust pledged virtually all of its capital—$50 million—to cover CME Group customer losses due to MF Global's misuse of customer funds.
- And, as noted above, CME Group recently launched the CME Group Family Farmer and Rancher Protection Fund to protect family farmers, family ranchers and their cooperatives against losses of up to $25,000 per participant in the event of shortfalls in segregated funds. Farming and ranching cooperatives also will be eligible for up to $100,000 per cooperative.

No other exchange or clearing house has taken such actions.

Government Oversight

Regulation at CME Group is subject to active Government oversight, primarily by the CFTC.

- CME Group's exchanges are registered as designated contract markets (DCMs) with the CFTC, and our clearing house is likewise registered as a derivatives clearing organization (DCO).
- In order to achieve registered status, we are required to fulfill substantial regulatory obligations codified in the CEA's 23 core principles for DCMs and 18 core principles for DCOs. These include core principles requiring that we establish structures and enforce rules to minimize conflicts of interest in our decision making processes and that we have appropriate procedures for resolving potential conflicts.
- The CFTC's Division of Market Oversight actively oversees DCM compliance with core principles and its Division of Clearing and Risk oversees DCO compliance. Exchanges and clearing houses are continually subject to both formal and informal reviews of how effectively we fulfill our regulatory mandates. In the event CME Group's exchanges or clearing house were to fail to comply with the core principles, the company could face significant sanctions, reputational exposure and even compromise the registration status which allows us to operate our markets.
- With respect to regulatory coordination, the CFTC and SEC allow the SROs on the futures side and securities side to coordinate their financial surveillance. We are signors to an agreement under the Intermarket Financial Surveillance Group (IFSG). This agreement allows the "experts" to focus on their piece of the puzzle, as well as to share information on common firms where we have concerns. The IFSG also meets once or twice per year to share information on regulatory developments and common firms. As noted above, we have recently established routine communications with FINRA for all of our common firms—the firm coordinators/relationship managers will reach out to each other to have these communications. We believe this will allow the coordinators on both sides to get to know one another better and to increase the sharing of information.

Enforcement

CME Group's effectiveness and assertiveness in regulating its markets is also reflected in the results of our surveillance and enforcement programs.

- In 2011, CME Group's exchanges opened approximately 700 regulatory inquiries, in addition to conducting proactive regular surveillance, and took 138 formal disciplinary actions against market participants.
- Two of those recent actions, resulting in $850,000 in fines and remedial actions, were taken against one of our most active proprietary trading firms for failing to properly supervise and test its deployment of automated trading systems. In another recently resolved matter, 18 brokers and locals in a particular market on the trading floor were fined more than $600,000 and subject to trading suspensions for engaging in noncompetitive trades that disadvantaged other market participants.

Direct regulation by the exchange offers our regulators unique proximity to the markets, market participants and the broader resources of the exchange. This fosters the development of expertise that not only makes our regulatory staff more effective, but also assists Federal regulators in our common objective of preserving the integrity of the markets.

- Most of our interaction with Federal agencies occurs with the CFTC, and its Division of Enforcement publishes a report of its activity for each fiscal year. Its most recent full report, for FY2010, noted that it took 57 enforcement actions.[3] In 30 percent of those actions, CME Group either referred the matter to the CFTC or provided assistance to the CFTC.
- Excluding enforcement actions outside of CME Group's regulatory purview, such as fraud in the FX cash markets, the percentage of CFTC actions in which CME Group referred the matter to the CFTC and/or provided assistance to the CFTC was 68 percent.
- Another example of how exchange-sponsored regulation and Federal regulation work together is a 2011 matter in which CME Group regulators initially acted to bar a party engaged in illegal practices from our markets and then referred the matter to the CFTC and Department of Justice. Both the CFTC and DOJ took enforcement action, and in December 2011, he was convicted in criminal court and sentenced to 44 months in prison and ordered to pay restitution of approximately $369,000 after having pled guilty to wire fraud.
- Last week, the CFTC acknowledged and thanked the NYMEX for its assistance in the recent Optiver market manipulation matter. "NYMEX's proactive surveillance program detected the subject trading by Optiver in the Crude Oil, New York Harbor Gasoline, and Heating Oil contracts and contributed to the cessation of the activity alleged in the complaint. NYMEX also provided the CFTC with important information from the NYMEX's own investigation of this matter, as well as other assistance."[4]

Exchange-sponsored regulation often allows for more expedient identification of potential issues given our knowledge of and proximity to the markets, as well as the ability to react more quickly and flexibly to potential market and regulatory issues; in certain matters, that speed can make all the difference between having the ability to freeze or recoup misappropriated money and losing it forever to wrongdoers.

- For example, in a series of three separate recent cases resolved in 2011, the CME Group exchanges were able to quickly identify suspicious activity in our markets involving off-shore parties seeking to misappropriate money from other unwitting market participants. We promptly referred those matters to the CFTC which subsequently filed suit against the parties in Federal court. Our ability to quickly detect this activity and assist the CFTC in its subsequent investigatory efforts resulted in fines and restitution of more than $3.5 million and, by quickly freezing funds, prevented $7.2 million more from being stolen.

Conclusion

The protection of the interests of customers and restoration of public confidence following the failure and unlawful actions by MF Global continue to be CME Group's highest priority. We look forward to working with Congress and the regulators to enhance customer protections and foster confidence in our markets.

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[3] The CFTC recently released statistics for FY2011, which noted the filing of 99 enforcement actions and the opening of more than 450 investigations, but the full report is not yet available.

[4] *http://www.cftc.gov/PressRoom/PressReleases/pr6239-12*