

TESTIMONY
OF
TERRENCE A. DUFFY
EXECUTIVE CHAIRMAN
CME GROUP INC.
BEFORE THE
SENATE COMMITTEE ON
AGRICULTURE, NUTRITION & FORESTRY
DECEMBER 13, 2011

Chairwoman Stabenow, Ranking Member Roberts, members of the committee, thank you for the opportunity to testify on the events surrounding the recent collapse of futures commission merchant (“FCM”) and broker-dealer (“BD”) MF Global, Inc. (“MFG”). 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®.

Introduction

As the Committee knows, on the morning of October 31, the Securities Investor Protection Corporation (“SIPC”) filed a petition with a Federal District Court in New York to place the futures commission merchant/broker-dealer arm of MFG into bankruptcy, which was immediately granted by the court. While over the course of our exchanges’ histories clearing members have filed for bankruptcy protection or been placed into bankruptcy involuntarily, the MFG bankruptcy is unprecedented in that it is the first time (i) there has been a shortfall in customer segregated funds held by one of our clearing members as result of the clearing member’s improper handling of customer funds and (ii) our clearing house was unable to transfer all customer positions and property in an FCM bankruptcy due to missing customer funds in a segregated customer account under the control of the FCM. Indeed, this is the first time in the industry’s history that a customer has suffered a loss as a result of a clearing members’ improper handling of customer funds.¹

MFG’s customers’ funds held by CME clearing house were securely held; in fact, we held \$1 billion in excess funds on behalf of those customers. Our number one priority is and has been to return to every MFG customer its rightful property. Our ability to do that, however, is limited. Since MFG was placed into bankruptcy, as a matter of law, the bankruptcy trustee has been in control of the process and all decisions regarding MFG assets and the money, securities and property of its customers. Indeed, we have worked diligently with the bankruptcy trustee to transfer MFG customer accounts to other FCMs along

¹ As recent examples, in both *Refco* and *Lehman*, which had large FCM operations, while non-commodities customers of Refco and Lehman 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 was discovered.

with a portion of the customers' collateral on deposit with CME Clearing. To date, CME Group with the bankruptcy trustee's permission has successfully transferred all (approximately 15,000) MFG customer accounts to other FCMs. The portion of customer collateral transferred to the new FCMs to margin customer positions was a decision by the bankruptcy trustee and outside the control of CME Group. CME Group continues to take steps and work with the bankruptcy trustee to facilitate the release of additional available customer funds.

There are ongoing investigations by the Department of Justice, the FBI, the CFTC, and the SEC into the events surrounding the MFG bankruptcy, including efforts to locate the missing segregated customer property and determining who was responsible for permitting the removal of that customer property from MFG's segregated accounts. Although we do not yet have these details, and are affirmatively prohibited from publicly divulging information obtained in connection with these federal investigations, I would like to share with you what CME Group does know and can share. To this end, I will briefly address the timeline of events in the days leading up to MFG's bankruptcy and the efforts to return to MFG's customers property that is rightfully theirs. Before I do that, I would like to provide the Committee with some background information regarding the clearing model in the futures industry, including the role and obligations of FCMs and derivatives clearing houses.

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 through 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 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 held in an account controlled by the FCM for the benefit of its customers.

Derivatives Clearing Houses

A clearing house acts as the seller to every buyer and buyer to every seller of every cleared contract. Twice a day it pays winners and collects from losers 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 firms with profitable positions. 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 systemic risk that could arise if the default of one clearing member leads 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 the CME, 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.

CME also was the designated self-regulatory organization (“DSRO”) for MFG. As MFG’s DSRO, CME was responsible for, among other things, conducting periodic audits of MFG’s FCM-arm and sharing any and all information 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. CME conducted audits of MFG, and all firms for which it was the DSRO, at least once every 9-15 months. The last audit was as of the close of business on January 31, 2011. This regulatory audit began subsequent to the audit date and was completed with a report date of August 4, 2011.

Nothing is more important to CME Group than protecting customer funds and this is exactly what our audits are designed to ensure. We reviewed the manner in which segregated funds were invested and required certain modifications which were immediately implemented. All other audit points were relatively minor and were immediately corrected. During this same period, MFG’s accounting and management controls were also reviewed by its CPA, which certified its books and records as of March 31, 2011, and by securities regulators, who required certain accounting treatment changes.

The Days Preceding MFG’s Bankruptcy

During the week of October 24, 2011, MF Global announced losses and suffered credit rating downgrades, which sparked rumors of its efforts to sell its brokerage business. On Thursday, October 27th, two of our auditors made an unannounced appearance at MFG’s Chicago offices to review the daily segregation report for the close of business on October 26th — the report stated that segregation was intact. Our auditors asked for the material necessary to reconcile the numbers on the segregation report to the general ledger and to third party sources. These procedures continued through Friday evening. At the time they left the office they had noted only immaterial discrepancies and we saw no indication that segregated funds were missing as of Wednesday October 26th. The segregation report for October 27th, which we received on the afternoon of the 28th, asserted that the firm remained in full compliance with segregation requirements.

Our auditors returned on Sunday, October 30th because we learned from the CFTC that the draft segregation report for Friday, October 28th, which had been provided to the CFTC that day, showed a \$900 million dollar shortfall in segregation caused by an “accounting error.” Our auditors, working with

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 approved 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.

the CFTC, devoted the rest of the day and night Sunday to find the so-called accounting error. No such error was ever found. Instead, at about 2 am Monday morning, MFG informed the CFTC and CME that customer money had been transferred out of segregation to firm accounts. Transfers of customer funds for the benefit of the firm constitute serious violations of our rules and of the Commodity Exchange Act. MFG was taken over by a SIPC Trustee on Monday. However, before the SIPC Trustee stepped in Monday, the segregation report for Thursday, October 27th, which had shown not only full segregation compliance but also \$200 million in excess segregated funds, was corrected by MFG to show a deficiency of \$200 million in segregated funds. Apparently based on MFG's segregation reports, additional transfers out of segregation occurred on Friday.

MFG's Bankruptcy, the Trustee and CME Group's Guarantee to the Trustee

As previously noted, prior to MFG's bankruptcy, a shortfall was discovered in the customer segregated funds held at MFG. For this reason, unlike prior bankruptcies by FCMs, customer positions and property were not able to be ported to another solvent clearing firm. Since MFG was placed into bankruptcy, as a matter of law, the SIPC Trustee has been in control of the process and all decisions regarding MFG assets and the money, securities and property of its customers. The Trustee is holding and/or has control of a substantial pool of customer property, but must be cautious about making a distribution before he completes all of his forensic work.

At the time it was placed into bankruptcy, MFG should have had about \$5.5 billion in customer segregated money, securities and property, but only held \$5 billion. Approximately \$2.7 billion of the \$5 billion had been transferred to clearing houses in the form of collateral necessary to support positions held by MFG customers. Approximately \$2.3 billion of the \$5 billion in customer segregated funds was subject to MFG's sole control because those funds were not needed to collateralize open positions on any exchange or clearing house. Approximately \$2.5 billion was securely-held by CME Clearing. Of that amount, CME Clearing held nearly \$1 billion of so-called excess collateral on behalf of MFG customers.

The information available suggests that there might be a shortfall in segregated funds, which currently could be between 13% and 19% of segregated funds, if the information proves correct. The Trustee must also consider that the shortfall may be even greater and that if he distributes based on that assumption and it turns out to be incorrect, some customers might get better treatment than others, in contravention of the Bankruptcy Code and CFTC Regulations.

To encourage the Trustee to make a prompt distribution of property to customers, CME Group made a \$550 million guarantee to the Trustee. The guarantee is not a payment made to customers, but rather a pledge of funding to the Trustee to provide him the flexibility to return more customer assets to customers now. In the event that an interim distribution by the Trustee gives customers more cash than they would have been entitled to in the claims process under the Bankruptcy Code and CFTC regulations, CME Group has proposed that our guarantee would be used to make the customer segregation asset pool whole for the amount of any over-distribution, up to \$550 million. As a result of the guarantee, we believe the Trustee should be protected if he decides now to distribute to every customer at least 75% of its account value. We believe these extraordinary measures are needed because an interim distribution by the Trustee could be delayed even further without them.

On November 29, the Trustee filed a motion with the Bankruptcy Court seeking permission to make a third interim distribution of customer funds in the coming weeks. Though details of the timing and amount of the distributions are still being worked out, the Trustee has stated that CME Group's financial guarantee will enable him to return more than 2/3 of the value of frozen customer segregated accounts, up to an additional \$2.1 billion, in roughly two to four weeks. The Trustee has stated that this distribution will include trapped account balances, dishonored checks and distributions with respect to warehouse

receipts and other customer property at MFG. Beginning next week, another \$2.0 billion-plus is expected to be released in reliance on our guarantee.

Separately, CME Group also announced that CME Trust would make its \$50 million in assets available to CME Group market participants that suffered losses due to MFG's improper handling of funds held at the firm level. The CME Trust was established in 1969 to provide financial protection to customers in the event a CME Group member firm was unable to meet its obligations to customers. CME Trust is providing virtually all of its capital, \$50 million, to CME Group market participants suffer losses as a result of MFG's improper handling of customer funds at the firm level. Unlike the \$550 million CME Group guarantee, which is a limited guarantee in connection with the goal of accelerating interim distributions by the Trustee, the \$50 million from the CME Trust will cover CME Group customer losses due to MFG's misuse of customer funds. We note that there also are civil and criminal penalties for misusing segregated funds as MFG did here, which, if recovered, would be used to address the current shortfall.

Conclusion

Our audit and spot check of MFG were performed at the highest professional level; the transfer of segregated funds out of the appropriate accounts was disguised from all regulators. CME Group has and continues to take extraordinary measures to minimize the impact that this unprecedented event has had on the futures industry and its participants. MFG appears to have broken a number of rules and obligations to protect customer collateral resulting in customer losses.

Nothing is more important to CME Group than protecting customers. CME has worked diligently to permit customers to liquidate positions, transfer accounts and recover a significant portion of the value of their accounts. We provided the Trustee comfort with a \$550 million guarantee, so that he could expedite the release of funds to customers without loss to the bankruptcy estate. Customers, however, are justifiably frustrated that they do not yet have access to their own money.

Some might conclude that the system failed because of this one instance when customers have been injured despite the prescribed system of segregation. Regulatory failures happen, unfortunately. Banks fail and the FDIC provides sometimes inadequate protection to depositors. The taxpayers get tapped. Securities firms fail and SIPC is irrelevant to any large account holders. The laws prohibit Ponzi schemes, yet hundreds are detected every year after the public has been robbed and the money evaporated. Insider trading happens every day. Enron explodes, Lehman fails. Insurance companies fail and policy holders lose. While it is clear that action is necessary to restore customer confidence and protect against future failures, the fact is that MFG broke rules by moving customer segregated funds out of an account over which it had control. A firm failed to comply with applicable rules, but that does not mean the segregation system is a failed system. To be clear, the customer segregation regime in the futures industry was not the cause of the losses that customers are suffering from today.

We look forward to working with the industry, regulators and Congress to explore potential improvements to increase security of customer funds held by FCMs and restore confidence in the futures industry.