PUBLIC STATEMENTS & REMARKS

Statement of Chairman Heath P. Tarbert in Support of Long-Awaited Updates to the CFTC's Bankruptcy Regime

April 14, 2020

In his 1926 novel *The Sun Also Rises*, Ernest Hemingway offers what is perhaps the best chronicle of the anatomy of a typical bankruptcy. In the novel, the character Mike Campbell is asked how he went bankrupt. He answers: "two ways . . . gradually and then suddenly."

As Hemingway's dialogue succinctly describes, bankruptcies often come on unexpectedly. A business's relatively minor financial or operational troubles may be exacerbated by a sudden crisis—whether a firm-level issue, or a national or even global event. Many catalysts for insolvency are entirely unpredictable, and we must be prepared with a bankruptcy regime that fosters a swift and equitable resolution.

Background on the CFTC's Bankruptcy Regime

Part 190 of the CFTC's rules, addressing commodity broker[1] bankruptcies, was enacted in 1983. Since that time, the commodity broker bankruptcy process and the state of the industry have gradually changed. Yet in the nearly four decades since, Part 190 has never been revised to keep up. This regime is intended to protect customer funds, but having antiquated rules does not help achieve that goal.

CFTC staff has therefore embarked on a process of updating Part 190 over the last several years, while a healthy economy made bankruptcies relatively unlikely. Today's proposal is a product of that hard work and engagement with external stakeholders and subject matter experts, including the American Bar Association.

To be clear, U.S. derivatives markets have weathered the recent volatility associated with the coronavirus pandemic admirably. The decision to issue this proposal was made long before COVID-19 emerged as a concern, and I hope and anticipate that it will not be necessary to use this updated bankruptcy regime to address fallout from current market conditions. But as I just noted, we cannot know for certain what the future holds—for bankruptcy often comes "gradually and then suddenly." We must therefore be prepared for all contingencies.

Accordingly, I am pleased to support today's proposal to update Part 190 for the 21st century. The proposal promotes the CFTC's core values in a number of ways, particularly the values of *clarity* and *forward thinking*. The proposal also furthers the agency's strategic goal of regulating our derivatives markets to promote the interests of all Americans.[2]

Clarity for Customers and Creditors

The proposed rule serves our core value of clarity by incorporating key principles and actual practice as they have evolved in commodity broker bankruptcies and related judicial decisions in the years since 1983.

A new introductory section of the rule would enumerate certain "core concepts" of commodity broker bankruptcies. This section is intended to offer a readily understandable primer on relevant law, policy, and practical considerations in this area, thereby providing a common mental framework for brokers, customers, bankruptcy trustees, courts, and the public. Among other things, this section provides an overview of the various classes of customer segregated accounts held by a commodity broker; the priority of public customers over non-public customers; the requirement of *pro rata* distribution; and the preference to transfer rather than liquidate open positions.

The proposal would further codify a number of approaches and practices that have proven necessary or desirable in commodity broker bankruptcies in the intervening years since 1983. For example, the proposed rule would authorize a bankruptcy trustee to treat a broker's customers in the aggregate for certain purposes, rather than handling each customer's account on a bespoke basis. This aggregate treatment has in practice proven unavoidable in more recent commodity broker bankruptcies, which have required disposition of hundreds of thousands of derivatives contracts—on behalf of thousands or tens of thousands of customers—within days or even hours. By making clear that such aggregate disposition of accounts is permissible and may even be likely to occur than the alternative, the proposal would provide greater clarity on potential outcomes for trustees, brokers, and customers.

Thus, for example, the proposed rule would expressly permit the trustee, following consultation with CFTC staff, to determine whether to treat open positions of public customers in a designated hedging account as specifically identifiable property (requiring the trustee to solicit and comply with individual customer instructions), or instead transfer or "port" all such positions to a solvent commodity broker where possible. This provision recognizes that requiring the trustee to identify hedging accounts and provide account holders the opportunity to give individual instructions is often a resource-intensive endeavor, which could interfere with the trustee's ability to act in a timely and effective manner to protect all the broker's customers.[3]

The proposal also includes explicit rules governing the bankruptcy of a clearinghouse, otherwise known as a derivatives clearing organization or DCO. Since its inception, Part 190 has contemplated only a "case-by-case" approach with no corresponding rules to spell out what would happen. While a DCO bankruptcy is extremely unlikely, it is important to provide *ex ante* clarity to DCO members and customers as to how a resolution would be handled. The proposed rule would favor following the DCO's existing default management and recovery and wind-down rules and procedures. This would allow the bankruptcy trustee to take advantage of an established "playbook," rather than being forced to form a resolution plan in a matter of hours during the onset of a crisis. The proposed rule would also give legal certainty to DCO actions taken in accordance with a recovery and wind-down plan filed with the CFTC by precluding the trustee from voiding any such action.

I support codifying these and other practices within our rules in order to provide greater transparency and predictability to brokers, customers, and other key stakeholders regarding permissible and expected procedures in a bankruptcy scenario.

Forward Thinking on Future Insolvencies

The proposed rule would update a number of provisions to reflect changes in financial technology since Part 190 was enacted 37 years ago. The enhanced discretion discussed above would in many cases help the trustee to account for the many-fold increase in transaction execution and processing speed, as well as the potential for large and unpredictable market moves given the rise of global trading and the 24-hour news cycle. In addition, the proposal would acknowledge digital assets as a physically deliverable asset class, in light of the listing of a number of physically delivered "virtual currency" derivatives contracts.

The proposed changes also reflect advances in communications technology. For example, under the proposed rule, notice of a bankruptcy filing and related filed documents would be provided to the CFTC by electronic rather than paper means. Furthermore, required customer notice procedures would no longer include publication in a "newspaper of general circulation" in light of the downward trend in newspaper readership. The proposal would similarly recognize changes from paper-based to electronic recording of documents of title.

Promoting the Interests of All Americans

Protection of customer funds is the lynchpin of the commodity broker bankruptcy regime of Part 190. The proposed rule includes a number of measures to enhance those protections, including by buttressing provisions already in place under existing law and regulation. In doing so, the proposal seeks to ensure that the CFTC's bankruptcy regime works for the derivatives market participants it was meant to serve—particularly public brokerage customers, with a special emphasis on customers using derivatives to hedge their commercial risks.

For example, the proposal reinforces the bankruptcy priority of public broker customers over "non-public" customers (*e.g.,* the broker's proprietary and affiliate accounts). It also strengthens the CFTC's longstanding position that shortfalls in segregated customer assets should be made up from the broker's general estate. As a result, our proposal makes clear that the CFTC's bankruptcy regime is complementary to relatively recently-enacted customer protection rules for day-to-day broker operations. [4]

The proposal would also further the preference—consistent with Subchapter IV of the Bankruptcy Code[5]—for transferring or "porting" customer positions to a solvent broker, rather than liquidating those positions. Porting of positions protects the utility of customer hedges by avoiding the risk of market moves between liquidation and re-establishment of the customer's hedging position. It also mitigates the risk that liquidation itself will cause such market moves. Among other measures, the grant of trustee discretion as to whether to treat hedging positions as specifically identifiable property will serve these objectives by facilitating porting of such positions *en masse*, promptly and efficiently, along with other customer property.

Conclusion

While updates to the CFTC's bankruptcy rules have been years in the making, I believe today's proposal was well worth the wait. The commodity broker resolution regime of Part 190 is respected throughout the world for its effectiveness and efficiency. In addition, Part 190 is important to the continued global competitiveness of American exchanges, clearinghouses, and market intermediaries. The proposed rule further enhances these features of our regime. Through its focus on promoting customer protection, clarity, and forward thinking, I believe the proposed rule would, if finalized, position us well for this decade and beyond.

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[1] The term "commodity broker" may refer either to a futures commission merchant ("FCM") or a derivatives clearing organization ("DCO"). 11 U.S.C. 101(6).

[2] *See* Remarks of CFTC Chairman Heath P. Tarbert to the 35th Annual FIA Expo 2019 (Oct. 30, 2019), available at https://www.cftc.gov/PressRoom/SpeechesTestimony/opatarbert2 (outlining the CFTC's strategic goals).

[3] The proposal would also grant the trustee needed discretion in other respects—for example, by allowing the trustee to modify the customer proof of claim form as appropriate for a particular bankruptcy.

[4] 17 C.F.R. § 1.23 (enacted in 2013 and revised in 2014) (requiring an FCM to contribute its own funds as "residual interest" to top up shortfalls in customer segregated accounts in the ordinary course of business).

[5] Statutory authority for Part 190 includes Subchapter IV of Chapter 7 of the Bankruptcy Code.

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