

PUBLIC STATEMENTS & REMARKS

Statement of Commissioner Dan M. Berkovitz on Proposed Amendments to CFTC Bankruptcy Regulations

April 14, 2020

Introduction

I support the proposed comprehensive amendments to the Commission's bankruptcy regulations. These regulations specifically address the disposition of assets, particularly customer property, of a bankrupt futures commission merchant (FCM) or derivatives clearing organization (DCO). The amendments provide a needed update to regulations that the Commission originally adopted in 1983 to account for significant changes in the size, complexity, and structure of our derivatives markets and market participants over the past 37 years. They also incorporate "lessons learned" from FCM bankruptcies during that period. FCM bankruptcies are rare, and a registered DCO has never gone bankrupt in the history of the CFTC. It is nonetheless important to make the bankruptcy process as effective and efficient as possible to protect, preserve, and return customer assets quickly.

The overarching purposes of the provisions in the U.S. Bankruptcy Code relating to the liquidation of commodity brokers are to protect the customers of such brokers and to mitigate systemic risks that could arise from a commodity broker bankruptcy.^[1] The Bankruptcy Code provides certain special protections for positions and property of customers of an FCM debtor so that the customers and current or future counterparties (and the clearing house) can be assured that those positions and property will not be treated as part of the FCM debtor's property and can be transferred to another FCM. In this way, a single FCM's bankruptcy will not cascade through derivatives markets by impacting customer positions and the counterparties to those positions.^[2]

In section 20(a) of the Commodity Exchange Act ("CEA") Congress gave the Commission broad authority to establish regulations regarding commodity broker debtors, including identifying which property shall be considered customer property (or commodity broker member property), the method for conducting the business of a commodity broker after the filing of a bankruptcy petition, and how net equity of customers is determined.^[3] Pursuant to CEA section 20, the Commission first adopted regulations to address these issues in 1983.

Need for Comprehensive Amendments

Since 1983, trading volumes and speeds have increased significantly. There are fewer FCMs, and much of the FCM business is concentrated in a few large firms, particularly with respect to swaps. Swap trading and clearing were added to the CFTC's jurisdiction following the 2008 financial crisis, and FCMs and clearing organizations trade and clear large volumes of swaps that were not considered when the Commission first adopted its bankruptcy regulations. The volume of cleared derivatives trades has also grown, and the amount of customer property held by FCMs and clearing organizations has correspondingly increased to tens of billions of dollars. This increase in the amount of customer property holdings and concentration of activity in fewer commodity brokers increases the complexity and risks posed by a commodity broker bankruptcy.

These changes in the derivatives industry since the Commission originally adopted its bankruptcy regulations warrant updating those regulations. In addition, the several FCM bankruptcies that have occurred during this period have provided valuable lessons regarding how the current regulations have operated in practice. It is appropriate to incorporate into the Commission's regulations these lessons to improve the timely and equitable distribution of customer assets. The preamble to the Proposal provides a good summary of the foundational principles underlying the Proposal and describes the large number of rule amendments to implement those principles. I will mention here a few aspects of the Proposal that I encourage commenters to address.

The Proposal is consistent with the bankruptcy code generally, while also recognizing the particular nature and uses of derivatives and their unique status under the code. The Proposal incorporates pro rata distribution among "public customers"^[4] as a class, with public customers having a priority interest in property held by a debtor FCM. This approach is appropriate because public customers are not participants in the business decisions of the FCM debtor, and pro rata distribution among public customers would put smaller customers on an equal footing with larger customers. The Proposal also grants greater discretion to the trustee that manages the bankruptcy process, in recognition of the complexity of modern commodity brokers, the speed of trading and price discovery, and the stated goal of prompt distribution of customer property.

Emphasizing *prompt* distribution of customer property over exacting *precision* in certain aspects of the bankruptcy proceedings is also a guiding concept in the Proposal. One of the lessons the Commission has learned from prior FCM bankruptcies is that many public customers rely on expected cash flows from commercial activities, including associated hedges, to fund ongoing operations. A failure to promptly distribute funds in a bankruptcy proceeding could therefore not only disrupt the cash flow and normal business operations of the debtor's customers, but also set in motion a chain of payment delays or failures in commercial markets.

While I believe the Proposal largely achieves an appropriate balance of equitable and prompt resolution of a bankrupt commodity broker, I look forward to receiving comments from stakeholders on these issues. In particular, I look forward to hearing from smaller commercial market participants who may not have the resources to actively defend their own interests in an FCM bankruptcy proceeding. Does the Proposal provide sufficient protections? Are the likely outcomes from the customer property distribution choices made in the Proposal expected to provide an equitable and timely result? I look forward to comments.

Comment Period

Speaking of comments, in light of the coronavirus emergency this country and the world are currently dealing with, 90 days is not sufficient time to review and comment on this nearly 400-page document. The Proposal amends almost every section in the existing bankruptcy regulations and adds several new provisions. A 90-day comment period would barely be long enough in normal times. Many stakeholders with an interest in these regulations are struggling day-by-day, hour-by-hour, just to maintain operations, generate cash flow, and pay employees. It is incongruous to ask the public to digest in 90 days a lengthy and complex rulemaking that took the Commission three years to develop. There is no statutory deadline or commercial imperative that compels a comment period of 90 days.

There is no need to rush commenters or the rulemaking process in the midst of a pandemic in an area as complex and as important as bankruptcy.

Conclusion

I commend the hard work of the Commission staff who have spent years working on this Proposal. The Proposal's deliberative, pragmatic choices reflect time spent learning from past bankruptcies and engaging with a number of interested parties (particularly the American Bar Association) on these issues. My office received a number of briefings on the Proposal and staff worked diligently to incorporate our comments throughout the process.

The Proposal is a comprehensive and complex effort to modernize the Commission's existing bankruptcy regulations. While FCM bankruptcies are rare and clearing organization bankruptcies have not occurred to date, such events can be highly disruptive to market participants. In some cases, they could impact the continued operation of markets altogether. It is critical for the Commission to update its bankruptcy rules to reduce the probability and extent of potential disruptions should an unfortunate event of bankruptcy occur.

I look forward to comments on the Proposal and working to finalize this rule in a thoughtful and deliberative manner.

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[1] See 11 U.S.C., Chapter 7, Subchapter IV—Commodity Broker Liquidation. “Commodity Broker” is defined to mean a futures commission merchant, foreign futures commission merchant, clearing organization, leverage transaction merchant, or commodity options dealer, for which there is a “customer,” as defined in the bankruptcy code. See 11 U.S.C. 101(6).

[2] The bankruptcy trustee is directed to “return promptly to a customer any specifically identifiable security, property, or commodity contract to which such customer is entitled, or shall transfer, on such customer’s behalf, such security, property, or commodity contract to a commodity broker that is not a debtor” subject to CFTC regulations. 11 U.S.C. 766(c). Section 764(a) of the Bankruptcy Code provides that “any transfer by the debtor of property that, but for such transfer, would have been customer property, may be avoided by the [bankruptcy] trustee” 11 U.S.C. 764(a).

[3] See CEA section 20(a), 7 U.S.C. 24(a).

[4] Generally, public customers are customers whose accounts must be segregated from the proprietary accounts of an FCM or of the members of a clearing organization. See Definition of “public customer” in regulation 190.01.