

TESTIMONY OF WILLIAM J. BRODSKY
CHAIRMAN AND CHIEF EXECUTIVE OFFICER
CBOE HOLDINGS, INC.
CHICAGO BOARD OPTIONS EXCHANGE, INC. (CBOE)

BEFORE THE

COMMITTEE ON AGRICULTURE
U.S. HOUSE OF REPRESENTATIVES

DECEMBER 8, 2011

Testimony of William J. Brodsky,
Chairman and Chief Executive Officer,
CBOE Holdings, Inc.
Chicago Board Options Exchange, Incorporated
before the
Committee on Agriculture,
U.S. House of Representatives
December 8, 2011

Mr. Chairman and members of the Committee, I am William J. Brodsky, Chairman and Chief Executive Officer of the CBOE Holdings, Inc. and its principal subsidiary, the Chicago Board Options Exchange, Incorporated (CBOE). For the past 37 years, I have served in leadership roles at major U.S. stock, futures and options exchanges, including 14 years in my current role as CBOE Chairman and CEO and 11 years as CEO of the Chicago Mercantile Exchange. I also recently completed a two year term as Chairman of the World Federation of Exchanges whose membership includes over fifty of the largest stock, options and futures exchanges in the world.

In addition to operating CBOE, which is the leading securities options exchange in the United States, CBOE Holdings also operates C2, which is a fully electronic options exchange, runs the CBOE Stock Exchange as a facility of CBOE, and owns and operates CBOE Futures Exchange. CBOE's Regulatory Division provides comprehensive regulatory services to each of these exchanges by conducting a broad array of market surveillances on those markets, by conducting various examinations of members of those exchanges, and by conducting investigations of the members of those exchanges based on the results of its surveillances, its examinations, or based upon complaints. In addition, all of the nine U.S. options exchanges, including CBOE and C2, are participants of a national market system plan, *i.e.*, the Options Regulatory Surveillance Authority (ORSA). ORSA was formed so that the U.S. options exchanges could jointly fulfill their statutory obligation to surveil for instances of insider trading involving listed options. The participants of ORSA have selected CBOE to be the exclusive regulatory services provider to look for insider trading in listed options on behalf of all of them.

Now, turning to the specific matter that is the subject of these hearings, we would first like to state that we have the deepest sympathy and concern for those customers of MF Global, Inc. (MFGI)¹ whose funds are currently frozen or may be lost or missing as a result of the recent MF Global bankruptcy. We take our self-regulatory responsibilities very seriously and, as one of the regulators responsible for overseeing MFGI, we have devoted many resources over the last few months to working with the Securities and Exchange Commission (SEC), the Financial Industry Regulatory Authority (FINRA), and other regulators to carefully evaluate the events leading up

¹ MF Global, Inc. is a wholly-owned subsidiary of MF Global Holdings USA, Inc. The ultimate parent is MF Global Holdings Ltd. MF Global, Inc. is a broker-dealer registered with the Securities and Exchange Commission. MF Global, Inc is also registered with the Commodities Futures Trading Commission as a futures commission merchant. When referencing the MF Global structure generally in this testimony, we will use the term "MF Global."

to and following the filing for bankruptcy by MF Global. We will attempt to describe in greater detail below the steps the CBOE has undertaken to date. In addition, we would like to assure the Committee that we will continue to make available all staff resources necessary to assist in an expeditious and thorough investigation of all matters related to the events at MF Global with the hopes that a resolution can be found to return as many customer funds as quickly as possible.

Although some of MFGI's activities that are the subject matter of this inquiry took place in the securities markets, by far the larger share of its activities took place in the futures markets. To clarify CBOE's role in overseeing MFGI, we believe it is instructive to first discuss briefly the federal regulatory scheme for the oversight of securities firms as established by law. There are two primary financial responsibility rules that are designed to protect customers' assets held in a securities account: the Securities and Exchange Commission's uniform net capital rule (Rule 15c3-1) and the SEC's customer protection rule (Rule 15c3-3). The net capital rule focuses on liquidity and is designed to protect securities customers, counterparties, and creditors by requiring that broker-dealers have sufficient liquid resources on hand at all times to satisfy claims promptly. Rule 15c3-3, or the customer protection rule, is designed to ensure that customer property (securities and funds) in the custody of broker-dealers is adequately safeguarded and generally segregated from the firm's own funds and securities. By law, both of these rules apply to the activities of registered broker-dealers, but not to unregistered affiliates. Assuming a securities firm complies in all respects with the operation of these two rules, securities customers should be able to recover all of the value of their funds and paid for securities in their account at that broker-dealer.

Securities customers are afforded further protection through the Securities Investor Protection Corporation (SIPC), which was created in 1970 as a non-profit, non-government, membership corporation, funded by member broker-dealers. The primary role of SIPC is to return funds and securities to investors if the broker-dealer holding those assets becomes insolvent. Customers of a failed brokerage firm get back all securities (such as stocks and bonds) that already are registered in their name or are in the process of being registered. Once this step is taken, the firm's remaining customer assets are then divided on a pro rata basis with funds shared in proportion to the size of claims. If sufficient funds are not available in the firm's customer accounts to satisfy claims within these limits, the reserve funds of SIPC are used to supplement the distribution, up to a ceiling of \$500,000 per customer, including a maximum of \$250,000 for cash claims. Additional funds may be available to satisfy the remainder of customer claims after the cost of liquidating the brokerage firm is taken into account.

SIPC generally covers notes, stocks, bonds, mutual funds and other investment company shares, and other registered securities. Among the investments that are ineligible for SIPC protections are commodity futures contracts (unless in portfolio margining accounts and defined as customer property under the Securities Investor Protection Act). As the Committee knows, a SIPC Trustee has been appointed for the estate of MF Global. On November 30, the SIPC Trustee filed a motion to transfer the majority of the remaining approximately 330 non-affiliate securities accounts to another broker-dealer. Under the terms of the proposed purchase agreement with the acquiring broker-dealer, if approved by the bankruptcy court, approximately 85% of customers with MFGI custody securities accounts will be fully reimbursed for the amount of their net equity claims. The remaining customers with net equity claims above \$1.25 million would

receive recoveries ranging from 60% to over 90% of those claims, depending upon the size of their claim. Additionally, these customers not receiving a full refund may yet be able to recover up to the full amount of their remaining claim depending on the outcome of the SIPC liquidation.

Supporting the federal securities regulatory scheme, of course, is the oversight of the securities firms by securities exchanges and FINRA to check that firms are, in fact, complying with the financial responsibility rules. Section 19(g)(1) of the Securities Exchange Act of 1934 (Act) requires every self-regulatory organization (SRO) registered as either a national securities exchange (e.g., CBOE) or a national securities association (e.g., FINRA) to examine its members and persons associated with its members to ensure compliance with the Act, the rules and regulations thereunder, and the SRO's own rules, unless the SRO is relieved of this responsibility pursuant to Section 17(d) or Section 19(g)(2) of the Act. With respect to a common member (*i.e.*, one that is a member of more than one SRO), Section 17(d)(1) authorizes the Commission to relieve an SRO of the responsibilities to receive regulatory reports, to examine for and enforce compliance with applicable statutes, rules, and regulations, or to perform other specified regulatory functions.

To implement Section 17(d)(1), the Commission adopted Rule 17d-1 under the Act. Rule 17d-1 authorizes the Commission to designate a single SRO as the designated examining authority (DEA) to examine common members for compliance with the financial responsibility requirements imposed by the Act, or by Commission or SRO rules. When an SRO has been designated as a common member's DEA, all other SROs to which the common member belongs are relieved of the responsibility to examine the firm for compliance with the applicable financial responsibility rules. On its face, Rule 17d-1 deals only with an SRO's obligations to enforce member compliance with financial responsibility requirements.²

The Commission designated CBOE to act as the DEA for MF Global, Inc. and CBOE has acted in this capacity with respect to MFGI (and its predecessors) since March 2003. CBOE is currently the designated examining authority for 160 registered broker-dealers. As a designated examining authority, the CBOE is responsible for enforcing the financial, margin, and books and records requirements of the SEC, the Federal Reserve Board and CBOE. This is accomplished through routine financial monitoring (on, at minimum, a monthly basis), routine main office examinations, and special investigations. During the time CBOE has served as the DEA for MFGI (and its predecessors), CBOE has conducted nine routine examinations of MFGI and three financial investigations to investigate specific matters. CBOE has taken disciplinary action against MFGI five times as a result of these examinations and investigations.

² Rule 17d-1 does not relieve an SRO from its obligation to examine a common member for compliance with the SRO's own rules and provisions of the federal securities laws governing matters other than financial responsibility, including sales practices and trading activities and practices. As such, CBOE also has responsibility to oversee MFGI's trading activity on the CBOE. CBOE is also a party to a Rule 17d-2 agreement with FINRA by which FINRA has assumed responsibility under the Act for overseeing the sales practice activities of common members, including MFGI.

Of course, MFGI is both a broker-dealer under the jurisdiction of the SEC and a futures commission merchant under the jurisdiction of the Commodities Futures Trading Commission. Consequently, MFGI has been subject to examination by both securities and futures regulators, but the number of accounts and the value of the customer assets are many times greater on the futures side than they are on the securities side. On the futures side, the Chicago Mercantile Exchange (CME) serves as the Designated Self Regulatory Organization (DSRO). In addition, FINRA has been involved in overseeing MFGI on the securities side as MFGI is a member of FINRA and is subject to FINRA's rules and oversight.

For the benefit of the Committee, I would like to discuss our understanding of how the issue of MF Global's exposure to European sovereign debt in the form of repurchase agreements came to be known and the various steps that were taken by CBOE and other regulators to oversee the risk of that exposure. CBOE became aware of the exposure of MF Global to European sovereign debt on or about May 31, 2011 from reviewing the company's annual audited financial statements. In the footnotes to the financial statements there was a discussion of the accounting treatment for repurchase agreements and reverse repurchase agreements when the maturity date of the underlying collateral is the same as the maturity date as the agreements. The firm believed that generally accepted accounting principles allowed these agreements to be treated as sales and not to be recognized as assets and liabilities on MFGI's balance sheet. Because the repurchase agreements did not appear on the financial statements, those agreements did not appear on the FOCUS Report³ submitted to regulators.

A couple of weeks later, on June 14, 2011, the SEC conducted its Rule 17h risk assessment program meeting with MFGI.⁴ Pursuant to ordinary practice, CBOE and FINRA participated in this conference call meeting. At this meeting, MF Global discussed organizational and management changes within the Firm, its strategic direction, financial information, risk management, current litigations, and some information about the European sovereign debt. Throughout July and August 2011, there were a number of conversations held involving two or more of these parties (MFGI, SEC, FINRA, and CBOE) regarding the sovereign debt exposure and discussions about how the risk of this exposure should be accounted for by the firm in calculating the required net capital, which the firm was required to keep to protect against market risk. It is our understanding that the SEC staff indicated that MFGI would need to take a net

³ FOCUS Report is an acronym for Financial and Operational Combined Uniform Single Report. The uniform regulatory report (Form X-17A-5) filed periodically by all broker-dealers pursuant to SEC Rule 17a-5. The reports detail capital, earnings and other pertinent information.

⁴ Rules adopted under Section 17(h) of the Securities and Exchange Act of 1934 require broker-dealers that are part of a holding company structure with at least \$20 million in capital to file with the Commission disaggregated, non-public information on the broker-dealer, the holding company, and other entities within the holding company. The purpose of the Broker-Dealer Risk Assessment program is for staff in the SEC's Division of Trading and Markets to assess the risks to registered broker-dealers that may arise from affiliated entities, including holding companies and keep apprised of significant events that could adversely affect broker-dealers, customers and the financial markets.

capital charge for these repurchase agreements due to the market risk exposure that they created for the MF Global entity. Although there may have been some room for debate about whether these agreements were properly left off of the balance sheet, CBOE nonetheless agreed with FINRA and the SEC that it was appropriate to apply a net capital charge to these positions given the significant market and credit risk posed by them.

The firm held further conversations with SEC staff in August suggesting that it should not have to take a net capital charge for the sovereign debt exposure. Ultimately, by the second half of August, however, FINRA, CBOE and the SEC all affirmed the determination that a net capital charge was appropriate. Because the securities regulators determined that it was necessary and appropriate for MFGI to apply this net capital charge retroactively, MFGI determined that it was in net capital deficiency at the end of July 2011. MFGI, however, was able to continue to operate at this point because the company had taken a number of steps to increase its net capital in anticipation that affirmation of a net capital charge would prevail. Among the steps that MFGI took to remain in net capital compliance included: a capital infusion from its parent company (MF Global Holdings USA, Inc.), the transfer of some sovereign bond positions to MF Global Finance USA, Inc as a reverse repo-to-maturity transaction, and the liquidation of foreign affiliates' open futures positions, which had the effect of reducing the firm's required net capital. It should also be noted that on August 31, 2011, CBOE joined CME in a meeting with MF Global for an overview of the transactions and the charge. CME agreed with the decision that had been made by the securities regulators requesting the adjustment to the firm's net capital.

During the time that the securities regulators were discussing the sovereign debt exposure issue with MFGI, CBOE separately initiated its own examination of MFGI on August 22, 2011. CBOE determined that it would review the European sovereign bond portfolio dating back to the beginning of 2011 to check whether the retroactive application of the increased capital charge would have had the effect of causing MFGI not to be in compliance with its financial responsibility rules retroactively. CBOE staff was on-site in MFGI's offices starting on September 7th and as is common practice, CBOE's examination focused on the most recent month in which all of the books have been closed, in this case July 2011. CBOE sent a formal request for documents pertaining to the financial investigation of the European Sovereign Debt portfolio on September 19, 2011. MF Global provided the requested documents on September 23, 2011.

Another primary focus of CBOE's examination (as is the case with all annual financial and operational examinations of this type) was to determine whether MFGI was appropriately segregating its customer funds in securities accounts in compliance with SEC Rule 15c3-3. CBOE spent considerable time looking closely at these issues. Any potential rule violations that the CBOE and SEC may identify to date could become the subject of disciplinary action against individuals at MFGI through the ongoing investigation.

Beginning on August 26, 2011, CBOE staff requested and received a variety of daily financial information from MFGI. These various computations were received daily through the end of October 2011. In addition, CBOE staff reviewed a variety of financial documents from the firm throughout this time to determine the financial health of the firm. It should also be noted that the financial information we received from the firm on a daily basis never showed a deficit of any

kind. In fact, until the bankruptcy filing, MFGI never reported excess net capital of less than \$100 million for any month-end since April 2008 (with the exception of its July 2011 revised net capital calculation mentioned above) and always maintained open funding from its parent if needed. Although MFGI routinely showed significant excess net capital, through CBOE's monthly closer-than-normal (CTN) surveillance reports (which CBOE generates from the monthly FOCUS reports), MFGI has been on a level of higher surveillance by CBOE for every month since December 2010 for various reasons. These monthly CTN write-ups are shared with SIPC, the SEC, the Options Clearing Corporation, the National Securities Clearing Corporation, and other securities self-regulatory organizations. During the final days of October, however, news about MF Global's exposure to sovereign debt surfaced, its stock price declined, and its credit rating was downgraded. Nevertheless, we received a preliminary net capital computation for Friday, October 28th on Saturday, October 29th which indicated the firm was still in net capital compliance. Just two days later, on Monday, October 31, staff at MF Global sent an email stating a "significant shortfall in segregated futures accounts." That same day MF Global Holdings, Ltd. and MF Global Finance filed for bankruptcy.

Almost every day for the last couple of months, CBOE staff has been on site at the firm continuing to review all elements of the firm's Rule 15c3-3 computation. We have also spent significant time piecing together all the money wires and transfers that occurred during the week of October 24th to 31st, 2011, including the funding of daily settlement needs, the funding of customer withdrawals, bank reconciliations, and the manner in which margin calls on the European Sovereign debt was met. We also have shared this information with the SEC, the CFTC, and SIPC. We, along with the other regulators, have been piecing together the wires that created the shortfall of the Segregated Futures accounts and have been consulting with each other on the events as we learn them. We are continuing to work with the SEC Chicago office, which in turn communicates daily with staff in SEC headquarters.

In conclusion, CBOE is still gathering information and we will need to learn more before we are able to make a full assessment of this matter and to be able to define and address any "lessons learned." We believe that the issues surrounding the MF Global bankruptcy provides an impetus for CBOE, FINRA, and the statutory regulators to discuss amongst ourselves whether there are rules or policies that should be adopted or amended to add a greater level of protection to customer assets in broker-dealer or FCM bankruptcy scenarios. Any new or amended rules or policies should necessarily also focus on ensuring that customer assets can be transferred as quickly as possible in these types of events. We also intend to take this opportunity to determine whether there can be any improvements in the nature of the cooperation among regulators when faced with a financially troubled firm subject to oversight by multiple entities.

We hope that the foregoing narrative was helpful to the Committee's understanding of the events leading up to and surrounding the bankruptcy of MFGI. We stand ready to continue to assist the Committee and its staff with its continued inquiry.

Committee on Agriculture
U.S. House of Representatives
Required Witness Disclosure Form

House Rules* require nongovernmental witnesses to disclose the amount and source of Federal grants received since October 1, 2009.

Name: William J. Brodsky

Organization you represent (if any): Chicago Board Options Exchange
and CBOE Holdings, Inc.

1. Please list any federal grants or contracts (including subgrants and subcontracts) you have received since October 1, 2009, as well as the source and the amount of each grant or contract. House Rules do **NOT** require disclosure of federal payments to individuals, such as Social Security or Medicare benefits, farm program payments, or assistance to agricultural producers:

Source: _____ Amount: _____

Source: _____ Amount: _____

2. If you are appearing on behalf of an organization, please list any federal grants or contracts (including subgrants and subcontracts) the organization has received since October 1, 2009, as well as the source and the amount of each grant or contract:

Source: _____ Amount: _____

Source: _____ Amount: _____

Please check here if this form is NOT applicable to you: X

Signature: William J. Brodsky

* Rule XI, clause 2(g)(5) of the U.S. House of Representatives provides: *Each committee shall, to the greatest extent practicable, require witnesses who appear before it to submit in advance written statements of proposed testimony and to limit their initial presentations to the committee to brief summaries thereof. In the case of a witness appearing in a nongovernmental capacity, a written statement of proposed testimony shall include a curriculum vitae and a disclosure of the amount and source (by agency and program) of each Federal grant (or subgrant thereof) or contract (or subcontract thereof) received during the current fiscal year or either of the two previous fiscal years by the witness or by any entity represented by the witness.*

PLEASE ATTACH DISCLOSURE FORM TO EACH COPY OF TESTIMONY.



Biography

William J. Brodsky Chairman and Chief Executive Officer

William J. Brodsky is Chairman and Chief Executive Officer of the Chicago Board Options Exchange and CBOE Holdings, Inc.

As Chairman and CEO of CBOE since 1997, Brodsky has overseen a period of tremendous growth and product innovation at the exchange, as well as the successful transformation of CBOE's traditional open-outcry market model into a world-class hybrid trading system. He serves as the options industry's leading advocate in shaping market policy and regulation. In June 2010, he guided CBOE through its demutualization, whereby the exchange converted its business model from a membership organization to a for-profit public corporation, and the initial public offering of CBOE Holdings, Inc. stock.

In October 2008, Brodsky was the first leader of a derivatives exchange to be named as Chairman of the World Federation of Exchanges (WFE) and served in that capacity for 2009 and 2010. He previously served as Vice Chairman of the WFE from 2007 to 2008.

Prior to joining CBOE, Brodsky served for 15 years at Chicago Mercantile Exchange (CME), where he oversaw the launch of the CME Globex trading system and played a pivotal role in the development and globalization of stock index futures. He joined CME in 1982 as Executive Vice President and Chief Operating Officer and, in 1985, was named President and Chief Executive Officer, a post he held until joining CBOE in February 1997.

Brodsky began his career as an attorney in the securities industry with the firm of Model, Roland and Company in 1968. In 1974, he joined the American Stock Exchange (AMEX) where he became head of options trading in 1976 and served as Executive Vice President for operations between 1979 and 1982. He also served for seven years as the AMEX representative on the board of The Options Clearing Corporation.

Brodsky serves as a director of Integrys Energy Group, Inc, an S&P 500 company. He is a member of the Federal Reserve Bank of New York's International Advisory Committee, the Council on Foreign Relations in New York City, and the Executive Committee of the Commercial Club of Chicago. He is also the former chairman of the International Options Markets Association (IOMA).

He serves on the Kellogg School of Management Advisory Council, as a trustee of Syracuse University and is a member of the Board of Directors of Northwestern Memorial Hospital. Brodsky holds an A.B. degree and a J.D. degree from Syracuse University and is a member of the Bar in Illinois and New York.