

Testimony

of

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before the

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Committee on Financial Services

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## **I. Introduction**

Chairman Neugebauer, Ranking Member Capuano, and members of the Subcommittee, on behalf of the Federal Reserve Bank of New York (the “New York Fed”), I appreciate the opportunity to discuss the New York Fed’s relationship generally with institutions with whom the New York Fed undertakes most monetary policy operations, known as primary dealers, and more specifically, our relationship with a former primary dealer, MF Global, Inc. Primary dealers serve as key counterparties to the New York Fed in its implementation of monetary policy and provide an important backbone for the government securities market. The “primary dealer” designation is conferred on those regulated institutions that we consider suitable business counterparties.

I recognize that questions are being asked about why the New York Fed designated MF Global as a primary dealer. As I will discuss, that decision came more than two years after MF Global initially approached the New York Fed about becoming a primary dealer. We made our decision after the firm went through a rigorous and careful application process, during which MF Global met all of our requirements. On October 31, 2011, we ended our counterparty relationship with MF Global and terminated its primary dealer status. We share the Subcommittee’s concern for the customers of MF Global who have experienced losses as a result of the firm’s bankruptcy, and have offered our assistance to the trustee upon whom the injured customers are relying. Through prompt and progressive action, the New York Fed protected its counterparty position and the interests of the American taxpayer, and we have sustained no loss.

## **II. The New York Fed’s Relationship with Primary Dealers**

Being a “primary dealer” means that a specific broker dealer or bank has been determined to be eligible to transact certain types of business with the New York Fed. It does not mean that

the New York Fed has undertaken supervisory functions over the designated primary dealer. Primary dealers serve as trading counterparties in the New York Fed's implementation of monetary policy. A primary dealer is required to participate consistently as a counterparty to the New York Fed in our execution of open market operations. These operations are done to implement the domestic policy directives of the Federal Open Market Committee ("FOMC"). Typically, the directives are satisfied by purchasing or selling U.S. government or agency securities, either outright or through repurchase agreements ("repo" or "reverse repo"). More recently, the FOMC directed the New York Fed to purchase agency mortgage backed securities ("ABMS") to satisfy the FOMC's dual mandate.

Primary dealers also provide the New York Fed's trading desk with market information and analysis that is helpful in the formulation and implementation of monetary policy. Dealers are also required to participate when the New York Fed, as fiscal agent of the Treasury, auctions U.S. government securities, and the dealer is obliged to participate in all auctions. Finally, the New York Fed holds more than \$3 trillion in reserves for foreign central banks and monetary authorities. A primary dealer is required to make reasonable markets for the New York Fed when it invests these official reserves.

In evaluating whether a particular firm may be designated as a primary dealer, the New York Fed will consider whether the firm has the experience and capability to meet the New York Fed's business requirements. A firm must meet particular capital requirements, demonstrate that it has sizable and sustained performance in business areas relevant to a primary dealer (namely, U.S. Treasury auction participation and cash and repo market activity in U.S. Treasuries), and a compliance program specifically related to its trading activities with respect to the cash and repo markets in U.S. Treasuries and any other markets in which the New York Fed transacts. The

functionality considered important to meet the unique business needs of the New York Fed may be different from the generic needs of other market participants. Consequently, the New York Fed has repeatedly and publicly stated that the designation of a firm as a primary dealer should not be regarded as a kind of “Good Housekeeping” seal of approval, and we have cautioned market participants that they should not take the primary dealer designation as a substitute for their own counterparty due diligence.

In January 2010, the Federal Reserve announced a revised Policy for the Administration of Relationships with Primary Dealers (the “Primary Dealer Policy” or the “Policy”). The revised Policy, like the policy it superseded, sets out the business standards and technical requirements for primary dealers. While the nature of the New York Fed’s relationship with its primary dealers had not changed, the previous policy, which dated back to 1992, needed to be refreshed. This need arose from dramatic changes that had taken place in the financial services industry during the last two decades. The revised Policy reflects greater emphasis on compliance and corporate governance. A primary dealer is now required to have compliance professionals dedicated to the business lines relevant to the primary dealer functions and activities at the firm. Furthermore, under the revised policy, the New York Fed will not designate as a primary dealer any firm that is, or recently has been (within the last year), subject to litigation or regulatory action or investigation that the New York Fed determines is material or otherwise relevant to the primary dealer relationship. The New York Fed instituted this “waiting period” so that it could evaluate whether the issue raised by the action or investigation had been sufficiently remediated by the firm.

The revised Policy, not surprisingly given the passage of time, raises the capital requirements for primary dealers. Now, a broker-dealer applicant must have at least \$150

million in regulatory net capital as computed in accordance with the SEC's net capital rule, while a bank applicant must meet the minimum Tier I and Tier II capital standards under the applicable Basel Accord and have at least \$150 million of Tier I capital as defined in the applicable Basel Accord. The New York Fed considered raising the capital requirement even higher but decided not to do so because of the exclusive effect the higher capital requirement would have on smaller firms.

In addition to establishing business standards for primary dealers, the revised Policy governs the application process for a prospective dealer (an "applicant"). In Part I of the application process, an applicant must submit a letter outlining its ability to meet the business standards set forth in the Primary Dealer Policy and its satisfaction of the new capital requirements. Each applicant is required to list its volume of activity in the last year (the "seasoning requirement") in the business areas relevant to the primary dealer relationship, including auction participation, cash market activity in U.S. government and agency securities, and repo and reverse repo activity in the same markets. The applicant must also describe how becoming a primary dealer fits with its current business and long-term business plan and provide an organizational chart showing a detailed ownership chain from the applicant to the ultimate parent company that lists the jurisdiction of formation for each entity in the chain.

If the New York Fed makes the discretionary determination that the applicant warrants further consideration, the revised Policy provides that the New York Fed will issue an information request ("Part II") seeking additional information concerning corporate governance, financial condition, regulation, the existing compliance regime, internal controls, and customer base. After submission of the Part II information, an applicant can expect at least six months of formal consideration by the New York Fed.

### **III. The New York Fed's Relationship with MF Global**

#### **A. The Application Process**

In December 2008, Donald Galante, Head of Finance, Trading, and Fixed Income Sales at MF Global, contacted a Senior Vice President in the New York Fed's Markets Group to inquire about the possibility of MF Global's broker dealer becoming a primary dealer. In early January 2009, representatives of MF Global, including Mr. Galante and the then-Chief Executive Officer of the firm, Bernard Dan, met with officials of the New York Fed's Markets Group. At the meeting, MF Global expressed its strong interest in becoming a primary dealer and provided the New York Fed with background information about the firm. On January 9, 2009, MF Global sent a formal letter requesting that the New York Fed consider MF Global as a prospective primary dealer. In the months immediately following its letter requesting consideration, MF Global started providing the New York Fed's trading desks with market color. The firm also began to participate directly in Treasury auctions, and to provide the New York Fed with mock-FR2004 reports.<sup>1</sup> Through these activities, the New York Fed had an opportunity to evaluate, on certain measures, how MF Global might perform as a primary dealer. At the same time that it was interacting with the New York Fed's Markets Group, MF Global also provided its financials for review by our Credit Risk Management area, and with information on its regulatory framework for review by our lawyers and compliance personnel.

In March 2009, after reviewing some of the materials MF Global provided, the New York Fed learned that the parent company of MF Global's U.S. broker dealer was domiciled in

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<sup>1</sup> Primary dealers are required to provide the New York Fed with information on a form called the "FR2004." The FR2004 reports weekly data on primary dealers' outright positions, transactions, and financing and fails in Treasury and other marketable debt securities.

Bermuda. New York Fed lawyers advised MF Global that, under the Primary Dealers Act,<sup>2</sup> which Congress passed in 1988, the Board of Governors would be required to conduct a so-called “country study” of Bermuda before MF Global could be considered for designation as a primary dealer. In a country study, the Federal Reserve must consider whether the country of incorporation would permit equal access by U.S. firms to its markets. If not, the application must be denied. The requirement is designed to foster competitive equality across countries. MF Global responded that it would change the corporate domicile of the parent company from Bermuda to Delaware. This change was effected in January 2010.

In April 2009, lawyers and compliance personnel at the New York Fed reached out to the CFTC, one of MF Global’s Federal supervisors.<sup>3</sup> In a conference call, the CFTC informed the New York Fed that while it took comfort from certain management changes made by MF Global, there remained several significant control issues. As a result, the CFTC ordered MF Global to overhaul its internal control structure with the assistance of an outside consultant. The CFTC explained that, after the consultant completed its work, the CFTC would review and assess the results of MF Global’s efforts in this area. New York Fed staff decided to wait for the CFTC’s assessment before taking a view on the firm’s suitability as a primary dealer. MF Global was advised in May 2009 that it would not be considered for designation as a primary dealer for at least six months because of its pending compliance issues.

During the months following the decision to proceed more deliberately with MF Global’s application, representatives of MF Global periodically contacted New York Fed officials to

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<sup>2</sup> 22 U.S.C. § 5341-42.

<sup>3</sup> In addition to the Federal supervisors, MF Global was supervised by certain designated self regulatory organizations (“DSRO”). On the futures side, the Chicago Mercantile Exchange serves as the DSRO. On the securities side, FINRA serves as the DSRO.

discuss relevant matters, including a pending CFTC investigation into certain trading irregularities at the firm and the legal issue concerning MF Global's corporate domicile in Bermuda. Also during this time period, the New York Fed was finalizing its revised Primary Dealer Policy. The New York Fed was considering including a provision in that Policy that would impose, subject to the New York Fed's discretion, a "waiting period" of one year for a primary dealer applicant that was facing relevant and material litigation, regulatory action, or investigation. When MF Global learned that such a provision was under consideration, it sought a meeting with William Dudley (who had become President of the New York Fed in January 2009) to discuss the impact the provision might have on its prospects for becoming a primary dealer. The New York Fed declined MF Global's meeting request.

In the fall of 2009, MF Global asked the New York Fed to re-open the application process that had been suspended earlier in the year during the pendency of the consultant's report. The New York Fed refused to take this step and informed MF Global that, putting aside the issues unique to MF Global, no primary dealer designations would be made until the revised Primary Dealer Policy was finalized. On December 17, 2009, before the revision, the CFTC announced a settlement with MF Global and issued a Consent Order Instituting Proceedings and Imposing Remedial Sanctions ("Order") for violations of the Commodities Exchange Act.

The CFTC had found four principal failings in MF's control environment. Over the course of several years, the firm had failed to: (i) supervise a trader's activities; (ii) transmit accurate prices in natural gas options positions; (iii) prepare proper and accurate trading cards; and (iv) maintain written records in at least one client file. The CFTC imposed a number of sanctions including a civil money penalty of \$10 million. MF Global also agreed to engage

Promontory Financial Group to conduct two independent reviews of the firm's compliance infrastructure.

On January 11, 2010, the New York Fed revised its Primary Dealer Policy. The Policy included the following provision:

The New York Fed will not designate as a primary dealer any firm that is, or recently has been (within the last year) subject to litigation or regulatory action or investigation that the New York Fed determines material or otherwise relevant to the potential primary dealer relationship. In making such determination, the New York Fed will consider, among other things, whether and how any such matters have been resolved or addressed and the applicant's history of such matters and will consult with the appropriate regulators for their views.

On the day the revised Policy was announced, the media reported that MF Global's CEO, Mr. Dan, had publicly expressed his hope that MF Global would become a primary dealer early in 2010.

On January 13, 2010, MF Global submitted Part I of its formal application to become a primary dealer. On January 22, 2010, MF Global submitted the more extensive information required by Part II of the primary dealer application. In response, on January 26, 2010, the New York Fed informed MF Global that under the New York Fed's revised Primary Dealer Policy, MF Global could not be designated a primary dealer until at least December 17, 2010 – one year after the CFTC Order was issued. MF Global responded the next day with a letter from Mr. Dan arguing that the CFTC action was not material or relevant to MF Global's primary dealer application, and asking the New York Fed to exercise its discretion to approve MF Global's application prior to the expiration of the one year period.

Within days of our receipt of Mr. Dan's letter, I received a telephone call from MF Global's outside counsel, Sullivan & Cromwell, who requested a meeting to allow MF Global to

present its case as to why the one year waiting period was unfair. On behalf of the New York Fed, I agreed to allow MF Global an opportunity to be heard on the issue.

In late February 2010, MF Global and its outside counsel met with the New York Fed and had the opportunity to advocate why the CFTC enforcement action should not cause the New York Fed to delay designating MF Global as a primary dealer. In response to MF Global's representations about the impact the delay could have on the firm, my colleagues and I explained that MF Global's application would be evaluated in accordance with the New York Fed's revised Policy, and that we were at the beginning of a review period that they should expect would take at least six months. We also advised MF Global that they should not have an expectation that the outcome of our review would automatically result in MF Global's being designated a primary dealer. Having made the decision to publicize its application for primary dealer status, MF Global needed to accept the possible negative consequences that might result from either a delay or a denial. Following the meeting with MF Global, lawyers in the New York Fed's Legal Group conducted a materiality analysis of the CFTC Order and concluded that the Order was material and that any approval of MF Global's application to become a primary dealer should be deferred until at least December 2010.

On March 23, 2010, I was informed by MF Global's General Counsel that Mr. Dan would be resigning as CEO and that Jon Corzine would be taking his place. In mid-April, MF Global's Head of Fixed Income Trading contacted an official in the New York Fed's Markets Group to request a courtesy meeting with the New York Fed to introduce Mr. Corzine as MF Global's new CEO. I, together with several of my colleagues, attended this meeting, which took place on June 1, 2010.

During the meeting, Mr. Corzine provided an update on MF Global's business plans, emphasizing the enhancement of its credit structure, by, for example, raising additional capital in the form of \$150 million in equity. The New York Fed staff updated the MF Global representatives on the status of MF Global's primary dealer application, and noted that we were in the midst of our formal review period. We emphasized that due diligence was continuing across the business, legal, compliance, and credit dimensions of the review process, and again reminded MF Global that the minimum time period for application review was six months after formal review had commenced. We again noted the requirement in the Policy that the New York Fed would not designate an applicant as a primary dealer if the applicant had been a respondent in an enforcement action within the last year that the New York Fed deemed material and relevant to the primary dealer relationship.

In the months following the June 1 meeting, New York Fed staff continued the process of gathering and evaluating data and information relevant to MF Global's application. MF Global had submitted a large volume of materials including, but not limited to, audited financial reports (with notes) from the previous three years as well as its most recent quarterly financial statements, copies of its tax returns, and policies and procedures relating to its compliance and ethics programs. With the consent of MF Global, the CFTC provided the New York Fed with its three most recent examination reports. In addition to the materials provided by MF Global as part of its application, the New York Fed staff in the credit, legal, and compliance areas made several requests to MF Global for additional information necessary to their evaluation of MF Global's application.

In early November 2010, the New York Fed staff visited the offices of MF Global and conducted an on-site review. Our requests at this point were heavily focused on credit issues

arising out of the financial and liquidity position of the broker dealer relative to the corporate entity at large. The New York Fed's principal concern was with the broker dealer because that legal entity would be our counterparty. MF Global responded to all of the additional information requests by mid-November.

A final assessment meeting on MF Global's application took place in December 2010. On January 21, 2011, Richard Dzina, a Senior Vice President in the New York Fed's Markets Group, circulated a memorandum concluding that MF Global had demonstrated a clear ability to meet each of the requirements for primary dealers set forth in the New York Fed's Primary Dealer Policy. Specifically, the memorandum stated that MF Global had demonstrated activity levels in the various markets in which the New York Fed's domestic trading desk transacts that suggested that MF Global had the capacity to provide sizeable, sustained performance in operations in Treasury repo and cash markets. The memorandum also noted that MF Global appeared capable of making markets for the New York Fed when the New York Fed transacts on behalf of its foreign official account holders. Based on auction awards during the application process, MF Global ranked in the third quintile of the then existing dealer population and ranked in the middle of the existing dealer population based upon Treasury cash and repo volume. The memorandum recommended that MF Global's application to become a primary dealer be approved. The New York Fed's legal, compliance and credit areas had no objections to the recommendation. I acted on behalf of the New York Fed's legal function. Brian Sack, Executive Vice President of the New York Fed's Markets Group, accepted Mr. Dzina's recommendation. On February 2, 2011, the New York Fed announced that MF Global had been designated a primary dealer, along with another applicant.

## **B. The Termination of MF Global as a Primary Dealer**

We exercised counterparty due diligence over MF Global from February 2011 until October of 2011, when its financial condition deteriorated abruptly and quickly. As noted, we were not the supervisor of MF Global; that role remained with the CFTC and the SEC. From October 24, 2011 until October 31, 2011, the New York Fed took a series of prompt and progressive actions with respect to MF Global that were designed to protect our position as counterparty and to safeguard the interests of the taxpayer.

On October 24, 2011, Moody's downgraded its credit rating for MF Global Holdings Ltd (the primary dealer's parent) from Baa2 to Baa3. On October 25, MF Global Holdings disclosed its largest quarterly earnings loss ever. Mr. Dzina reported the downgrade to the New York Fed's Chief Risk Officer. Later, on October 25, the New York Fed's President requested an analysis of what a bankruptcy of MF Global might mean for U.S. markets. We actively communicated with MF Global to assess whether MF Global had the ability to perform on its commitments with the New York Fed. On October 26, 2011, I telephoned the Regional Administrator of the SEC in New York, and a member of the Commission's staff in Washington, DC, to ensure that the SEC was aware of the gravity of the situation. Members of my legal staff contacted the CFTC for the same reason. We learned that the SEC and the CFTC planned to go into MF Global on October 27, 2011, and we understand that they did.

A review of the New York Fed's counterparty exposure led us to take a series of actions. First, the New York Fed mitigated exposure by excluding MF Global from certain primary dealer operations. Second, as a result of our review of exposure to MF Global, we focused on a series of seven AMBS trades with MF Global, which were still outstanding as forward settling transactions. These trades subjected the New York Fed to exposure to MF Global if the firm became insolvent prior to the settlement date and the market price had moved in the New York

Fed's favor. In such circumstances, the New York Fed would have to replace these trades by buying the securities at a higher rate. To protect against this exposure, the New York Fed asked MF Global to execute an Annex to the Master Securities Forward Transaction Agreement (the "MSFTA"), an agreement that MF Global and the New York Fed executed when MF Global became a primary dealer. The Annex would require MF Global to post margin to the New York Fed. The margin, which was calculated daily and subject to daily call, would protect the New York Fed from credit risk exposure arising from the unsettled trades. Following the execution of the Annex, MF Global posted the initial margin in the afternoon of October 28. Later in the day, the New York Fed made another margin call pursuant to the Annex that would be due on Monday, October 31, at 10 a.m. Third, by the close of markets on Friday, October 28, the future of MF Global was in doubt. Consequently, at approximately 6:00pm on that day, the New York Fed informed MF Global that MF Global was suspended from conducting new business with the New York Fed as a primary dealer (but trades that had not yet settled were still open).

Over the course of the prior week and the weekend, the New York Fed participated in calls with various agencies that regulated or otherwise oversaw MF Global, including the SEC, the CFTC, and the U.K. Financial Services Authority, to monitor the events with respect to MF Global's attempts to stabilize its liquidity situation and sell the firm or its assets.

As we all now know, late on October 30, 2011, the prospects for a sale of MF Global dissipated. Before the markets opened on Monday, October 31, the New York Fed publicly announced that it had suspended MF Global from conducting new business as a primary dealer (the decision that it had informed the firm about on Friday evening). Later that morning, MF Global failed to meet the New York Fed's margin call by the prescribed time of 10:00am. As a result, the New York Fed declared an event of default under the MSFTA, and issued a notice of

termination of outstanding unsettled AMBS trades. The New York Fed subsequently entered the market, executed replacement trades for the terminated trades with MF Global, and served MF Global with a notice of calculation of loss (based on the cost of those replacement trades and other costs). The New York Fed then exercised its contractual right under the MSFTA to set off the calculated loss against the margin provided to the New York Fed by MF Global.<sup>4</sup> Through these actions, the New York Fed protected its position as counterparty and safeguarded the interest of the taxpayer. To be clear, the New York Fed sustained no loss from its relationship with MF Global.

During the afternoon of October 31, the Securities Investors Protection Corporation (“SIPC”) applied to the United States District Court for the Southern District of New York for the appointment of a trustee to oversee the orderly wind-down of MF Global. Immediately following that filing, the New York Fed terminated MF Global’s status as a primary dealer. The New York Fed ultimately returned the excess margin to the SIPC trustee, in accordance with the trustee’s instructions.

#### **IV. Conclusion**

To conclude, the New York Fed designated MF Global as a primary dealer to meet our highly specialized needs, and we followed our Primary Dealer policy to the letter without fear or favor. In our role as counterparty, we took prompt and progressive actions to protect the New York Fed and the taxpayer from loss, and we succeeded in this endeavor. The New York Fed is deeply concerned about MF Global’s customers who have sustained losses as a result of MF Global’s collapse. We have pledged our assistance and cooperation to the trustee, whenever we

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<sup>4</sup> The set off amount was calculated as the amount of unrealized appreciation on the securities from the trade date through the time of the replacement of the trades plus legal fees related to the termination and replacement transactions.

can be helpful, and we hope that our testimony is useful to the Committee in its oversight activities.