Testimony on the "Collapse of MF Global"

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Chairman Neugebauer, Ranking Member Capuano, members of the Subcommittee:

My name is Robert Cook, and I am the Director of the Division of Trading and Markets at the Securities and Exchange Commission ("SEC"). Thank you for the opportunity to testify on behalf of the SEC concerning the collapse of MF Global.

The bankruptcy of MF Global has resulted in serious hardship for many of its customers, who have experienced significant delays and uncertainty with respect to their ability to access their own assets. More broadly, the firm's collapse and the apparent shortfall in the segregated accounts of futures customers highlight the need for financial firms and regulators to remain vigilant in ensuring that customer assets are appropriately protected and made readily available to customers whenever they may be needed.

To that end, the SEC and its staff are working with the trustee, our fellow financial regulators, and other authorities to facilitate the prompt identification and return of MF Global customer assets, and to investigate and pursue any potential violations of law that may have contributed to customer losses. While the examination and review of the causes and implications of the collapse of MF Global are ongoing, I would like to provide the Subcommittee with an overview of the regulation of MF Global's SEC-registered broker-dealer subsidiary prior to the

bankruptcy, the key events leading up to the bankruptcy, the status of approximately 330 securities accounts in the liquidation proceedings, the securities customer protection regime, and recent efforts to further improve that regime.

Regulation of MF Global Prior to its Bankruptcy

MF Global Holdings Ltd. (together with its subsidiaries, "MF Global") was a publicly traded holding company that conducted financial activities through a number of subsidiaries located in various countries. MF Global Inc. ("MFGI"), an indirect subsidiary of the holding company, was dually registered with the Commodity Futures Trading Commission ("CFTC") as a futures commission merchant ("FCM") and with the SEC as a broker-dealer. As of October 31, MFGI had approximately 36,000 futures customers[1] and approximately 330 custodial accounts for non-affiliated securities customers.[2] MFGI also was authorized by the Federal Reserve Bank of New York to act as a primary dealer in the U.S. Treasury markets. Another affiliate, MF Global UK Limited, was regulated by the U.K. Financial Services Authority ("FSA"). There was no consolidated supervisor of MF Global.

The "front-line" supervisory function for the securities activities of broker-dealers is performed by the self-regulatory organizations ("SROs") of which a broker-dealer is a member, i.e., the Financial Industry Regulatory Authority ("FINRA") and the various securities exchanges. Where a broker-dealer is a member of multiple SROs, one SRO is the "designated examining authority" ("DEA") responsible for examining the securities component of the firm's

[1] Expedited Motion to Approve Further Transactions and Distributions for MF Global Inc. United States Commodity Futures Customers (Nov.29, 2011).

[2] The approximately 330 securities accounts are those custodial accounts that had positive net equity on October 31 and exclude accounts of affiliates and firm insiders. Motion of James W. Giddens, Trustee for the Liquidation of MF Global Inc., for an Order Authorizing the Sale, Transfer, and Assignment of Certain Customer Securities Accounts (Nov. 30, 2011) ("Trustee Securities Account Transfer Motion").

financial and operational programs, including its compliance with the SEC's capital and customer protection requirements. In the case of MFGI, the DEA was the Chicago Board Options Exchange ("CBOE"), although FINRA was also closely involved in the oversight of MFGI's broker-dealer activities. The futures activities of financial firms, including related segregation requirements, are overseen by the CFTC and the futures SROs, in this case the National Futures Association and the Chicago Mercantile Exchange.

The SEC oversees the regulatory functions of securities SROs and regularly communicates and coordinates with them on examinations and other matters. In its SRO role, CBOE conducted examinations of MFGI for compliance with financial responsibility rules. FINRA conducted examinations for compliance with other issues, such as sales practice requirements. In addition, the SEC's national examination program conducts its own risk-based examinations of SEC-registered broker-dealers. Unlike some other regulators of financial firms, the SEC does not have an "on site" presence at any broker-dealer and generally does not have examination staff dedicated solely to particular broker-dealers.

Key Events Leading Up to the Bankruptcy

Although the investigation of the causes of MFGI's collapse is ongoing, we can highlight our current understanding of several key events leading up to its failure.[3]

Capital Treatment of Repo-to-Maturity Transactions

[3] The events described in this testimony are based on the SEC staff's current recollection and information, including information from third parties that is currently unconfirmed. The SEC staff's knowledge of the facts surrounding the bankruptcy of MF Global continues to develop, and accordingly the description of events herein is subject to change.

During 2010, MFGI reportedly started acquiring significant proprietary positions in European sovereign debt, which were financed using an instrument called a "repo-to-maturity" ("RTM").[4] By August 2011, MFGI had accumulated several billion dollars of European sovereign debt positions using RTM transactions.[5]

In the summer of 2011, based on analysis of MFGI's financial statements, FINRA and CBOE staffs raised questions with MFGI about whether the firm was properly recognizing its RTM positions for purposes of its regulatory net capital computations. The net capital rules of the SEC required MFGI to maintain certain minimum amounts of liquid capital based on its business activities (similar to the capital rules of the CFTC). After consulting with the SEC staff, the SRO staff informed MFGI that under the SEC rule it must take capital charges for the European sovereign positions as if they were on the firm's balance sheet, notwithstanding the fact that the bonds had been "sold" pursuant to the RTM transactions.

In August, representatives of MFGI contacted SEC staff in Washington, D.C., to request a meeting to present the firm's view that the RTM positions should be subject to lesser capital charges than those determined by the SRO and SEC staffs. On August 15, 2011, members of the SEC staff met with representatives of MF Global, including its Chief Executive Officer, Jon S. Corzine. After further consultations, FINRA staff informed MFGI on or around August 24 that the staffs' collective view had not changed.

There were also discussions with MFGI regarding: (1) whether MFGI needed to provide a formal net capital deficiency notice under SEC Rule 17a-11, which generally requires broker-dealers to provide a "hindsight notice" of any deficiency in their compliance with the SEC's

[4] An RTM is a form of a repurchase agreement. A repurchase agreement generally involves the sale of a bond – here, European sovereign bonds – coupled with an agreement to repurchase the bond at a later date at a fixed price. In an RTM transaction, the repurchase date is the same date as the maturity date for the bonds that were sold.

[5] Notes to Statement of Financial Condition (Mar. 31, 2011), note 4.

financial responsibility rules; and (2) whether MFGI needed to restate and refile its "FOCUS" report for July 2011, which could result in the net capital deficiency becoming public.[6] Pursuant to Rule 17a-11, once the deficiency was identified, the firm was required to file the "hindsight notice" and on August 25, filed the deficiency notice. After consultation with the SEC staff, the SRO staff also required the firm to file an amended FOCUS report for July 2011. On August 31, MFGI amended its FOCUS report for July to reflect the required capital charges, reporting a "hindsight" capital deficiency of approximately $150 million as of July 31, 2011. At the holding company level, MF Global reported the change in capital treatment at MFGI in an amendment to MF Global's public filings on September 1.[7]

Bankruptcy of MF Global

During the week of October 17, press reports noted that regulators had directed MF Global to increase capital at MFGI due to concerns about MFGI's capital treatment of its RTM positions. On Tuesday, October 25, MF Global announced quarterly earnings, reporting a net loss of $192 million for the three months ending September 30. Its stock price declined close to 50% that day, and continued to decline over the week. During this same week, certain credit rating agencies downgraded the firm's credit rating or put it on negative watch. According to MF Global, during this time certain counterparties and customers were reducing their exposures to MFGI, and MFGI was undertaking significant efforts to reduce the size of its balance sheet.

SEC staff commenced a continuous on-site presence at MFGI's New York office beginning on October 27 to monitor the situation, and to engage with senior management

[6] FOCUS reports (Financial and Operational Combined Uniform Single Reports) are filed by broker-dealers with their DEA pursuant to SEC Rule 17a-5.

[7] See MF Global 10-Q/A (filed Sept. 1, 2011).

regarding the steps that were being taken by the firm. On Friday, October 28, MF Global management reported on developments to Chairman Mary Schapiro and SEC staff, including myself. According to the firm, it was in discussions with various parties regarding potential strategic transactions, such as the sale of the firm, the sale of the RTM positions, and the sale of the firm's customer business. We continued to receive updates from our on-site staff and from calls with firm management on Saturday and Sunday. By Sunday afternoon, MF Global reported that the firm was close to concluding a strategic transaction with a potential purchaser of the customer business of MFGI in a transaction that would provide customers with continued access to their accounts. The SEC staff worked closely with the CFTC and FSA to review the key transaction terms to determine that they provided adequate customer protection. However, MF Global subsequently reported in the early morning hours of October 31 that MFGI had identified a significant deficiency in its segregated accounts for futures customers, and that the acquisition negotiations had terminated.

At that point, after considering MFGI's financial condition and available alternatives, the SEC staff determined in consultation with the CFTC that the safest and most prudent course of action to protect customer accounts and assets was to initiate a liquidation proceeding under the Securities Investor Protection Act ("SIPA").[8] A referral was made to the Securities Investor Protection Corporation ("SIPC") on the morning of Monday, October 31, 2011. On that same day, the U.S. District Court for the Southern District of New York entered an order granting the application of SIPC to commence a liquidation of MFGI under SIPA and appointing James W. Giddens as trustee for the liquidation. Also on October 31, MF Global Holdings Ltd. separately filed a voluntary bankruptcy petition in the U.S. Bankruptcy Court for the Southern District of

[8] SEC-CFTC Statement on MF Global, Oct. 31, 2011, *available at* http://sec.gov/news/press/2011/2011-230.htm.

New York, and MF Global U.K. Limited entered administration proceedings in the United Kingdom.

MFGI Liquidation and the Status of Securities Customers

The preferred method of returning securities customer assets in a SIPA liquidation generally is to transfer those assets in bulk to another solvent broker-dealer. This approach typically provides customers with access to their securities and funds more quickly than the claims process. Accordingly, shortly after the initiation of the SIPA proceeding, the trustee solicited from other broker-dealers interest in taking over MFGI's securities customer accounts. Based on the available expressions of interest, the trustee on November 30 filed an expedited motion seeking authorization to sell and transfer substantially all securities custody accounts to another broker-dealer. This sale and transfer would cover approximately 330 accounts held for non-affiliated securities customers of MFGI. The proposed transaction was approved by the Bankruptcy Court last Friday, December 9, and the trustee has commenced the transfer process.

Securities customers will be able to trade their securities and use their funds as soon as the transfer is complete. Moreover, each customer will have the option of maintaining securities accounts at the receiving broker-dealer or moving the account to a different broker-dealer selected by the customer. The trustee estimates that this initial transfer will restore 100% of the net equity for more than 80% of these securities customers and that the remaining securities customers will receive at least 60% of their net equity plus an amount up to the limit of the protection afforded by SIPC (up to $500,000).[9] Customers who do not receive 100% of their net equity through this initial transfer may be able to receive additional funds, up to the aggregate

[9] Trustee Securities Account Transfer Motion, supra note 2.

amount of their net equity, if the trustee determines that there is customer property available for that purpose.

Throughout this process, the SEC staff has been working closely with the trustee and SIPC, seeking to make the securities customers of MFGI whole and to expedite the return of their assets. We appreciate the efforts of SIPC and the trustee in seeking to provide securities customers access to their funds and securities as quickly as possible, and we will continue to support those efforts.

Securities Customer Protection Regime

MFGI acted as a "carrying" firm for a small number of securities customers, meaning that it held their funds and securities. MFGI also had additional securities customers for which it executed purchases and sales of securities but did not hold funds and securities – rather, such securities were held at other custodians that settled transactions executed through MFGI on a "delivery versus payment" basis.

As a broker-dealer registered with the SEC, MFGI was subject to the SEC's customer protection rule. This rule requires that each broker-dealer that holds securities or cash for customers take two primary steps to safeguard customer property. These steps are designed to protect customer property by prohibiting broker-dealers from using customer funds and securities to support their proprietary positions or expenses. Together with the applicable SEC capital requirements, this regime also is meant to ensure that, if the broker-dealer fails, segregated securities and funds will be readily available to be returned to the customers.

The first step required under the customer protection rule is that the broker-dealer must maintain physical possession or control over securities that customers have paid for in full. This

means that if a customer has fully paid for his or her securities, they cannot be used by the broker-dealer in its business – for example, they cannot be pledged as collateral to finance the firm's own trades or to raise funds for the firm to invest. Further, if a customer has a margin loan, the customer protection rule strictly limits the amount of securities that can be used by the broker-dealer for financing purposes. The goal in both cases is to require broker-dealers to hold customer securities in a manner that allows those securities to be readily available to customers, either on demand or upon the liquidation of the firm.

The second step required under the customer protection rule is that the broker-dealer must maintain a reserve in an account at a bank for the benefit of customers in an amount that exceeds the net funds attributable to customer positions. These funds cannot be invested in any instrument that is not guaranteed, as to principal and interest, by the full faith and credit of the U.S. government. The amount owed to customers must be computed pursuant to a prescribed formula, normally on a weekly basis. A broker-dealer cannot make a withdrawal from the reserve account until the next computation, and then only if the computation indicates that there is an excess amount in reserve – greater than what is required to be maintained under the rule. In essence, this requirement complements the protection afforded to fully paid securities held at a broker-dealer by requiring the firm to maintain a reserve of funds or U.S. government guaranteed securities equal to its net cash obligations attributable to customer positions.

A broker-dealer that complies with the customer protection rule – isolating customer funds and securities through these steps and separating them from the firm's proprietary business – should be in a position to return all the securities and funds it owes to customers if it falls into financial difficulty. If a broker-dealer cannot return all the securities and funds owed to customers, SIPC has the responsibility to institute a proceeding under SIPA to liquidate the

broker-dealer. Under SIPA, all securities customers share *pro rata* in the available securities customer property before any other types of creditors of the broker-dealer. If the available securities customer property is insufficient to return 100% of the amount owed to securities customers, SIPC may advance up to $500,000 per customer (of which $250,000 can be used to make up a cash shortfall).

Recent Efforts to Improve the Securities Customer Protection Regime

The securities customer protection regime, including the SEC's rules and oversight, along with the SROs' rules and oversight and SIPC protection, has generally worked well for customers over time. While our near-term focus has been on working with SIPC and the trustee to return securities and funds to affected customers of MFGI, the SEC will continue to strive to identify further enhancements to its customer protection regime.

For instance, in June 2011 the SEC proposed amendments to the broker-dealer financial reporting rule in order to strengthen the audits of broker-dealers, including their practices for maintaining custody of customer assets, as well as to enhance the SEC's oversight of the way broker-dealers handle their customers' securities and funds. Specifically, the proposal would:

- Enhance the current requirement that a broker-dealer undergo an annual audit by a public accounting firm registered with the Public Company Accounting Oversight Board by requiring the accounting firm to examine the broker-dealer's compliance, and internal controls over compliance, with SEC net capital and custody requirements.
- Facilitate inspections of a broker-dealer's custody practices by allowing regulators access to the work papers of the broker-dealer's auditor and the ability to discuss any findings with relevant accounting firm personnel.

- Require that a broker-dealer file with the SEC a new "Form Custody" every quarter. This form would contain more detailed information about how broker-dealers maintain custody of customer assets in order to further facilitate verification by examiners that customer assets are being properly protected.

The SEC staff is evaluating the comments received in response to the proposal and preparing a recommendation to the Commission.

The SEC also continues to work with the SROs to help strengthen broker-dealer financial responsibility requirements. For example, also in June, the SEC approved a FINRA rule filing to establish registration, qualification, examination, and continuing education requirements for certain operations – or "back office" – personnel, including those who handle customer assets. In addition, just last month the SEC published for comment a FINRA proposal to require each member firm to file certain additional financial or operational schedules or reports to supplement existing filing requirements. FINRA believes this proposal would make income and expense data more transparent, which would in turn improve the oversight of broker-dealers. The SEC staff is currently reviewing the comments received on the proposal.

Conclusion

In conclusion, the failure of MF Global has resulted in a significant hardship for the firm's customers. While the causes of the failure of MF Global are still under investigation, the SEC and its staff are working with our fellow financial regulators and other authorities to facilitate the prompt identification and return of all customer assets.

I would be pleased to answer any questions you may have.