SPENCER BACHUS, AL, CHAIRMAN

United States House of Representatives
Committee on Financial Services
Washington, D.C. 20515

BARNEY FRANK, MA, RANKING MEMBER

December 12, 2011

Memorandum

To: Members, Committee on Financial Services

From: Committee Staff

Subject: Oversight and Investigations Subcommittee Hearing on "The Collapse of MF Global"

The Oversight and Investigations Subcommittee will hold a hearing on "The Collapse of MF Global" at 1:00 p.m. on Thursday, December 15, 2011, in Room 210 of the Capitol Visitor Center. This hearing will examine the collapse of MF Global, its oversight by regulators and self-regulatory organizations, and the consequences of its collapse on customers. The hearing will also examine the Federal Reserve Bank of New York's decision in early 2011 to approve MF Global's application to become a primary dealer.

This will be a two-panel hearing with the following witnesses:

Panel I

- Mr. Daniel M. Berkowitz, General Counsel, Commodity Futures Trading Commission
- Mr. Robert Cook, Director, Division of Trading and Markets, U.S. Securities and Exchange Commission
- Mr. Terry Duffy, Executive Chairman, CME Group
- Mr. Richard Ketchum, President, Chairman and Chief Executive Officer, Financial Industry Regulatory Authority
- Mr. James Kobak, Jr., Chief Counsel to Mr. James Giddens, Bankruptcy Trustee for MF Global Inc.
- Mr. Thomas C. Baxter, Jr., General Counsel, Federal Reserve Bank of New York

Panel II

- The Honorable Jon Corzine, former Chief Executive Officer, MF Global
- Mr. Bradley Abelow, Chief Operating Officer, MF Global

Background

On October 31, 2011, MF Global Holdings Ltd., the parent company of MF Global Inc., filed for Chapter 11 bankruptcy in the United States Bankruptcy Court for the Southern District of New York. On the same day, the Securities Investor Protection

Corporation initiated liquidation proceedings under the Securities Investor Protection Act for MF Global Inc., and the bankruptcy court appointed James Giddens as trustee for the liquidation. Shortly after MF Global's bankruptcy filing, the firm's chief executive, Jon S. Corzine resigned and hired a criminal defense attorney.

U.S. financial regulators and law enforcement agencies are investigating missing customer funds, which, by law, must be kept in segregated accounts. On November 21, 2011, the bankruptcy trustee reported that the "apparent shortfall in what MF Global management should have segregated at US depositories may be as much as $1.2 billion or more." Commodities brokers have failed before, but the shortfalls in the accounts of MF Global's customers mark the first time that customers have suffered losses resulting from a clearing member's improper handling of customer funds. As the CME Group reported, "the failure of MF Global and the firm's mishandling of customer segregated funds is absolutely uncharted territory for this industry." The shortfall in customer funds affects thousands of customers who are now unable to access the full balance of their accounts. Some of these customers are small business owners such as grain elevator operators, who are now unable to hedge their positions against price fluctuations.

Regulatory Framework

Before it collapsed, MF Global operated as a global investment bank whose businesses included a futures commission merchant (FCM), registered with the Commodity Futures Trading Commission (CFTC), and a broker-dealer, registered with the Securities and Exchange Commission (SEC). On February 2, 2011, the firm became one of 20 primary dealers authorized to trade U.S. Government securities with the Federal Reserve Bank of New York.

A regulatory framework safeguards accounts belonging to the customers of FCMs and broker-dealers. Section 4d(a)2 of the Commodity Exchange Act requires futures commission merchants to segregate customers' money, securities and property. Rule 15c3-3 of the Securities Exchange Act of 1934, known as the "Customer Protection Rule," prohibits broker-dealers from using client funds for working capital or for financing the broker-dealers' proprietary positions. Broker-dealers must hold customer cash in a reserve account at a bank separate from the firm's accounts.

The customers of FCMs and broker-dealers are also protected by capital requirements. Because MF Global was both an FCM and a broker-dealer, it was subject to the SEC's capital requirements, which are more stringent than those of the CFTC. The SEC's Uniform Net Capital Rule, Rule 15c3-1, required MF Global to maintain a positive balance sheet and to meet certain capital-to-equity ratios to continue operating. Although the CFTC and SEC were not MF Global's "safety and soundness" regulators, the CFTC and the SEC were responsible for ensuring that MF Global could meet obligations to its customers and exchanges. MF Global was required to report on its net worth to the SEC and various self-regulatory organizations. Such reporting was supposed to allow MF Global's regulator to take actions to protect the firm's customers if its net worth dropped substantially.

In addition to the SEC and the CFTC, several self-regulatory organizations had authority over MF Global as well, including the National Futures Association, the Financial Institution Regulatory Authority (FINRA), the Chicago Board Options Exchange (CBOE) and the CME Group. FINRA was responsible for MF Global's trading practices and sales activities, as well as other issues. The CBOE was responsible for enforcing SEC regulations through regular monitoring. The CME Group was responsible for day-to-day monitoring and regular auditing of MF Global, including reviewing daily segregated funds statements.

The exchanges and clearinghouses to which MF Global belonged had supervisory authority over the firm as well. Altogether, MF Global reported to and was supervised by 20 U.S. regulators, self-regulatory organizations, and exchanges. Given the number of regulators and organizations responsible for supervising MF Global, coordination and information sharing were necessary for the regulatory regime to work effectively.

MF Global before Bankruptcy

MF Global had a 230-year history as a commodities broker. In its most recent 10-K report, MF Global described itself as "one of the world's leading brokers in markets for commodities and listed derivatives" and "an active broker-dealer in markets for commodities, fixed income securities, equities, and foreign exchange."[1] MF Global also offered investor services, such as clearing, settlement and portfolio reporting, record-keeping, and market research.

Despite its long history, MF Global was a troubled firm. Moody's rated MF Global debt Baa2, with a negative issuer outlook in November 2009. Moody's maintained that rating through October 24, 2011, and Moody's ratings for MF Global from November 2009 through October 2011 highlighted the firm's increasing leverage and declining revenues. MF Global also sought to conceal the extent of its indebtedness from investors in its quarterly SEC filings. The *Wall Street Journal* found that from late 2009 through 2011, MF Global's short-term borrowings at the end of each quarter, which was the figure reported in its filings, were much lower than its average and peak borrowing throughout the quarter.[2]

In March 2010, Jon S. Corzine—a former U.S. senator and Governor of New Jersey and one-time chairman of Goldman Sachs Inc.—joined MF Global as its Chairman and Chief Executive Officer. At that time, the firm posted a fiscal year loss of $137 million. According to annual reports, regulatory filings, and former MF Global employees, the change in leadership was expected to return the firm to profitability by shifting MF Global's business towards investment banking and increased principal trading, in which the firm would be using its funds to trade for its own account.

Crucial to this shift towards investment banking was MF Global's becoming a primary dealer with the Federal Reserve Bank of New York.[3] On February 2, 2011, less

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[1] Securities and Exchange Commission Form 10-K MF Global Annual Report for Fiscal Year ending March 30, 2011 *available at* http://www.sec.gov/Archives/edgar/data/1401106/000119312511145663/d10k.htm.

[2] Michael Rapoport, "MF Global Masked Debt Risks," Wall Street Journal, Nov. 4, 2011, *available at* http://online.wsj.com/article/SB10001424052970204621904577015950376439984.html.

[3] On a conference call on February 3, 2011, the day after MF Global was designated as a primary dealer, Mr. Corzine said, "We would expect this designation to support the building of our client base, broadening of our financing capacity, and an improvement in our understanding of the flow of funds in the global marketplace." MF Global Q3 2011 Earnings Call Transcript *available at* http://seekingalpha.com/article/250635-mf-global-ceo-discusses-q3-2011-results-earnings-call-transcript?all=true&find=%22mf%2Bglobal%22%2BAND%2B%22primary%2Bdealer%22

than nine months before MF Global failed, the Federal Reserve Bank of New York approved MF Global's application to become one of twenty primary dealers, even though MF Global had a weak credit rating and was suffering financial losses. But the change in leadership and strategy did not stop the firm from continuing to lose money, and MF Global continued to post losses during Mr. Corzine's tenure. For the fiscal year ending March 31, 2011, the firm posted a yearly loss of $81.2 million. The firm's final quarterly earnings statement dated October 25, 2011—released just days before the bankruptcy—reported total assets of $41 billion and a loss of $119 million for the quarter.

Apart from its financial troubles, MF Global had a history of compliance failures. The National Futures Association lists 80 regulatory actions taken against MF Global since 1997, of which three were taken by the CFTC and 77 were taken by exchanges. Of the 77 taken by exchanges, 31 were taken by the CME Group.

In the past four years, MF Global experienced two high-profile compliance and risk management failures that resulted in substantial fines and penalties. In 2007, the CFTC required MF Global to pay a $2 million penalty to the CFTC and $75 million to the receivership estate of a hedge fund whose funds were mishandled by MF Global. In 2009, the CFTC required MF Global to pay $10 million to resolve risk management, compliance, and supervision violations related to an unauthorized trading incident that resulted in losses of $141 million.

The Collapse of MF Global

Although investigations continue, MF Global's collapse was most likely caused by margin calls on its trades in European sovereign debt. MF Global's public disclosures about the trade were opaque. For example, MF Global's earnings statement on October 25, 2011, disclosed a $6.3 billion long position in European sovereign debt, net of hedging transactions designed to mitigate issuer risk. An earlier quarterly SEC filing from August 3, 2011, disclosed a $6.4 billion net exposure to European sovereign debt. The October statement also disclosed a hedge of a $1.3 billion short position in French government bonds. Because additional hedges were not explicitly disclosed, MF Global's full exposure to European debt could have been much higher than $6.3 billon. A larger figure for European positions was listed in MF Global's latest 10-Q quarterly report to the SEC for the period ending June 20, 2011. The 10-Q states that MF Global entered repurchase agreement transactions in the amount of $16.5 billion, of which 69.3% were collateralized by European sovereign debt. If this figure represents MF Global's total exposure to European sovereign debt, then these trades amounted to $11.5 billion, which would constitute over 20% of the total balance sheet of the firm.

MF Global's $6.3 billion net bet on European sovereign debt involved a "repo-to-maturity" trade on the sovereign debt of Italy, Belgium, Spain, Portugal, and Ireland that would mature in 2012. In a repurchase agreement, a firm that holds bonds or securities pledges them as collateral to a counterparty in exchange for cash. The transaction is made with the understanding that the pledged collateral will be redeemed later at a higher price. MF Global acquired European bonds, and then pledged these bonds as collateral to borrow money. Through these repo transactions, MF Global borrowed money at a lower rate than the coupon payments on its European bonds. MF Global would profit on the difference between the coupon payments it received from the bonds and the interest rate of the money it borrowed.

MF Global's repo transactions exposed it to two risks—sovereign default and liquidity risk.[4] Before MF Global's failure, its counterparties began to question both the value of the European bonds MF Global had pledged as collateral and MF Global's ability to continue as a going concern. In mid-June 2011, FINRA flagged MF Global's exposure to European sovereign debt and instructed the firm to hold additional capital. After an unsuccessful appeal to the SEC in August, MF Global posted more capital and re-issued its 10-Q on September 1 to reflect this additional capital. Concerns about MF Global began to spread after the Moody's downgraded MF Global to one notch above junk status on October 24, 2011. On October 27, 2011, Fitch Ratings downgraded MF Global to junk status. Although Standard and Poor's threatened to downgrade MF Global in the week before the firm's bankruptcy, it did not downgrade MF Global debt until after the firm declared bankruptcy. As its credit rating fell, MF Global's counterparties required it to post larger amounts of margin, which made its liquidity problem worse.

When liquidity dried up for MF Global, and the firm could no longer fund itself, MF Global looked for another firm to purchase it. Reportedly, Mr. Corzine worked over the weekend of October 30-31, 2011, to find a buyer. However, negotiations to sell the firm to the Interactive Brokers Group collapsed when it appeared that significant amounts of money was missing from the segregated accounts of MF Global's customers.[5]

MF Global eventually confirmed that customer funds were missing. On October 31, 2011, MF Global notified the CFTC, the SEC, the CME Group, and the CBOE about a significant shortfall in segregated customer accounts hours before it filed for bankruptcy. The Bankruptcy Trustee believes that the shortfall may be as much as $1.2 billion or more. Although MF Global is being liquidated pursuant to the Securities Investor Protection Act, SIPA protection available to the customers of MF Global Inc.'s broker-dealer is not available to MF Global's commodities customers. It is still unclear how the segregated customer funds disappeared. Investigations into these missing funds have been opened by U.S. Attorneys in New York and Chicago, the Federal Bureau of Investigation, SEC, and CFTC. Customers are concerned that the missing customer funds were used by MF Global to meet margin calls.

The Role of Mr. Corzine in MF Global's Collapse

Weaknesses in corporate governance may have contributed to the collapse of MF Global. The $6.3 billion European sovereign trade was orchestrated by Mr. Corzine acting in his capacity as MF Global's CEO. Mr. Corzine spoke openly about his intention for MF Global to become a "mini-Goldman" and operate as an investment bank.[6] To achieve this goal, Mr. Corzine directed that MF Global increase its principal trading. During an October 25, 2011 investor conference call Mr. Corzine explained: "Our positions and the judgment about risk-mediation steps are my personal responsibility."

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[4] See Written testimony of Jon S. Corzine before House Committee on Agriculture, December 8, 2011, p. 10, *available at* http://agriculture.house.gov/pdf/hearings/Corzine111208.pdf and John Gapper and Izabella Kaminska, "Downfall of MF Global," Financial Times, November 4, 2011, *available at* http://www.ft.com/intl/cms/s/0/2882d766-06fb-11e1-90de-00144feabdc0.html#axzz1d8stQdLh.

[5] Felix Salmon, "What happened at MF Global?," Reuters, November 1, 2011, *available at* http://blogs.reuters.com/felix-salmon/2011/11/01/what-happened-at-mf-global/

[6] Andrew Ross Sorkin, "It's Lonely Without the Goldman Net," New York Times, October 31, 2011, *available at* http://dealbook.nytimes.com/2011/10/31/its-lonely-without-the-goldman-net/

Mr. Corzine's $6.3 billion trade conflicted with industry practice and sound risk management. CEO involvement in specific trades is unusual. For example, at Morgan Stanley and Goldman Sachs, top executives rarely initiate specific trading strategies, and large trades must be reviewed and approved by internal risk managers and multiple layers of management. By contrast, not only did Mr. Corzine initiate the European sovereign trade, it also appears that the $6.3 billion trade was not subject to ordinary review and approval. Only MF Global's board of seven directors could have blocked the trade.[7] In late 2010, MF Global's Chief Risk Officer, Michael Roseman, expressed concerns several times to Mr. Corzine about the firm's ability to shoulder the liquidity risk posed by European sovereign debt in positions that exceeded $2 billion. These concerns notwithstanding, MF Global went on to take far larger positions in European sovereign debt, and in January 2011, Roseman was told he would be replaced.