

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

March 23, 2012

Memorandum

To: Members, Committee on Financial Services

From: Committee Staff

Subject: Oversight and Investigations Subcommittee Hearing on "The Collapse of MF Global: Part 3"

The Oversight and Investigations Subcommittee will hold a hearing on "The Collapse of MF Global: Part 3" at 2:00 p.m. on Wednesday, March 28, 2012, in Room 2128 of the Rayburn House Office Building. This hearing will examine the events that took place during the final week of MF Global's operations before the firm filed for bankruptcy on October 31, 2011.

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

Panel One:

- Ms. Laurie Ferber, General Counsel, MF Global Holdings Ltd.
- Mr. Henri Steenkamp, Chief Financial Officer, MF Global Holdings Ltd.
- Ms. Christine Serwinski, Chief Financial Officer for North America, MF Global Inc.
- Ms. Edith O'Brien, Assistant Treasurer, MF Global Inc.

Panel Two:

- A representative of JPMorgan Chase
- A representative of the Financial Accounting Standards Board (FASB)

Background

Throughout the week of October 24, 2011, MF Global Inc. faced a severe cash crunch as its counterparties, creditors, and customers reacted to credit rating downgrades, poor quarterly earnings, and growing concerns about its exposure to European sovereign debt. Over the course of that week, MF Global's financial position deteriorated, but the firm represented to its regulators and self-regulatory organizations that its customers' segregated funds were safe. By the early morning of October 31, 2011, MF Global disclosed a significant shortfall in its customers' segregated funds—a shortfall without precedent in the history of the futures industry.

Later that morning, MF Global Holdings Ltd. (MF Global Inc.'s parent company) filed for bankruptcy and a Securities Investor Protection Act (SIPA) liquidation proceeding was filed for MF Global Inc. U.S. financial regulators and law enforcement agencies, including the Department of Justice, the Commodity Futures Trading Commission (CFTC), the Securities and Exchange Commission (SEC), and the bankruptcy trustees for MF Global Holdings and MF Global Inc. are investigating the missing customer funds.

Before the Collapse: Liquidity Stress Predicted

The circumstances that triggered MF Global's collapse were anticipated by some of MF Global's executives. MF Global's former Chief Risk Officer, Michael Roseman, warned against increasing the firm's proprietary investments in European sovereign debt through its repurchase-to-maturity agreements (RTMs). In testimony at the Subcommittee's February 2, 2012 hearing, Mr. Roseman said that he had informed the firm's Chief Executive Officer, Jon S. Corzine, as well as the firm's board of directors, that a concentration of European sovereign positions could drain liquidity from the firm if its RTM counterparties demanded additional margin on existing positions or demanded deeper haircuts on the repurchase collateral already posted.¹

Shortly before MF Global's collapse, other executives also recognized the liquidity risk posed by the firm's RTM positions. The firm's Treasury, Finance, and Risk departments produced a "Break the Glass" plan dated October 13, 2011, that evaluated various stress scenarios that would result if the firm's credit rating was downgraded. The plan anticipated that a ratings downgrade would cause "significant disruption" to MF Global's ability to finance itself. The plan posed a series of questions regarding the RTM portfolio, and noted that the RTMs were the "biggest draw on cash today" and that the firm "need[s] a clear strategy on this."

After the Downgrades: Liquidity Pressure Mounts

In late October 2011, three credit rating agencies downgraded MF Global, which put substantial liquidity stress on MF Global in the firm's final week. On Monday, October 24, 2011, Moody's downgraded MF Global to one notch above junk status, noting the firm's liquidity risk and leverage due to its European sovereign debt exposure. On October 26, Standard and Poor's (S&P) placed MF Global on "CreditWatch with negative implications." On October 27, Moody's and Fitch Ratings downgraded MF Global to junk status; on October 31, so did S&P.

Henri Steenkamp, MF Global Holdings Chief Financial Officer, attempted to persuade the three rating agencies not to downgrade the firm, but without success. In an October 24 e-mail to S&P, Mr. Steenkamp wrote that he believed "MF Global's capital and liquidity has never been stronger," and that "MF Global is in its strongest position ever as [a] public entity." In an October 27 e-mail to Fitch Ratings, Mr. Steenkamp tried to appeal a preliminary downgrade by pointing to actions taken by MF Global to liquidate its RTM portfolio and other assets.

¹ Prepared Testimony of Mr. Michael Roseman, former Chief Risk Officer, MF Global Holdings Ltd before Oversight and Investigations Subcommittee of House Committee on Financial Services, February 2, 2012.

Margin Calls and Haircuts

In response to the ratings downgrades, MF Global's counterparties to its European RTM trades began to demand additional margin and deeper haircuts on assets posted as collateral. On October 24, MF Global Holdings Chief Risk Officer Michael Stockman sent an e-mail that listed the firm's net funded exposure to European sovereign debt from Greece, Ireland, Italy, Spain, and Portugal at \$7.687 billion and \$422 million for Belgium and France. By the close of business on October 28, MF Global had posted an additional \$945 million in margin and haircut charges according to a document produced by MF Global's Treasury department. On Monday, October 31, MF Global's London staff requested an additional \$310 million to cover the additional margin demanded by MF Global's counterparties against the RTM portfolio. In response to the demand, Edith O'Brien, Assistant Treasurer of MF Global Inc., responded by an e-mail sent with high importance to MF Global staff, "PLEASE DO NOT RELEASE THIS COLLATERAL."

Developments with MF Global's Clearing Bank and Creditors

As MF Global struggled to meet these margin calls, new developments in its longstanding business relationships further stressed available liquidity. JPMorgan Chase (JPMC) had multiple business relationships with MF Global: JPMC was not only MF Global's clearing bank, it was one of the firm's custodian banks for its segregated customer funds and one of its creditors. On October 27, following Fitch's downgrade and the second Moody's downgrade, JPMC terminated its customary intraday credit extension relationship with MF Global. JPMC's intraday credit lines to MF Global were similar to overdraft protection, and provided as much as \$432 million of unsecured liquidity to the firm. Also on October 27, JPMC, which was the lead agent for a \$1.2 billion revolving unsecured credit facility, dispatched a team to MF Global's New York headquarters to monitor and report back on MF Global's liquidity. As MF Global's clearing bank, JPMC took steps to ensure that assets sold by MF Global were in fact owned by MF Global before forwarding sale proceeds. In a meeting with regulators on October 28, Mr. Corzine and Mr. Steenkamp expressed frustration with JPMC's delays in transmitting sale proceeds. Other creditors moved to end relationships altogether.

October 28, 2011 Transfer from Segregated Customer Account

On the afternoon of Friday, October 28, MF Global transferred \$200 million from a segregated customer account at JPMC to cover a \$175 million overdraft in one of MF Global's JPMC accounts in London.² MF Global Holdings Global Treasurer Vinay Mahajan wrote in an e-mail he sent early that afternoon that JPMC was "holding up vital business in the U.S. as a result" of the overdrawn account and that the account must be "fully funded ASAP." Ms. O'Brien wrote in an e-mail that the transfer was "Per JC's [Jon Corzine's] direct instructions."

Recognizing the liquidity stress that MF Global was operating under, JPMC sought to validate the appropriateness of the transfer. JPMC Chief Risk Officer Barry Zubrow called Mr. Corzine directly to seek assurances that the funds transferred to cover the overdraft were excess funds that belonged to MF Global and not customer funds. JPMC

² Futures commission merchants and broker-dealers are permitted to, and in the ordinary course do, deposit funds in excess of segregation requirements in segregated accounts. These excess funds belong to the firm, and may be transferred out of the segregated accounts.

then sent Mr. Corzine a draft letter to be signed by Ms. O'Brien, seeking broad assurances that all transfers—past, present and future—from MF Global's JPMC segregated customer accounts complied with the CFTC's segregation rules. Laurie Ferber, General Counsel for MF Global Holdings, reviewed the letter, but thought it was too broad and sought to restrict the letter's scope to the October 28 transfer.

The Final Weekend

Saturday, October 29, 2011

On the weekend before its bankruptcy filings, MF Global senior management worked round the clock to resolve the firm's liquidity problems by finding a purchaser for the business or a portion thereof, and selling off the firm's asset portfolio, including its European RTM portfolio. On October 29, several revised versions of the JPMC letter were drafted by MF Global, but the letter was never returned to JPMC. A series of e-mails sent by Ms. O'Brien and Ms. Ferber and other lawyers revealed that Ms. O'Brien was reluctant to sign the letter. At 5:30 p.m., Mr. Corzine updated regulators about the firm's negotiations with potential purchasers and the firm's asset sales. Mr. Corzine identified Interactive Brokers and JPMC as parties most interested in purchasing MF Global.

Sunday, October 30, 2011

On Sunday morning, CFTC Chairman Gary Gensler advised CFTC staff to set specific deadlines for MF Global to provide information on its customer segregated funds. According to a timeline provided to the Subcommittee by the CME Group, on October 30, CFTC staff in MF Global's Chicago office saw a draft of the MF Global October 28 customer-segregated funds statement which showed that customer funds were missing. Throughout the afternoon and evening, MF Global staff in New York and Chicago and MF Global's regulators worked to get more information on the shortfall, but e-mails sent by federal regulators and self-regulatory organizations to MF Global reveal that the firm was not forthcoming with information. When MF Global missed a 2:00 p.m. deadline for providing information, the CFTC's Chief Counsel for Clearing and Risk e-mailed staff from MF Global's offices of Treasury and General Counsel to inform them that the lack of data and supporting documentation was "driving adverse inferences."

Around 6:00 p.m., MF Global staff from New York and Chicago discussed the deficiency with officials from the CFTC and the CME Group, and attributed the deficiency to an accounting error. MF Global Inc.'s Chief Financial Officer, Christine Serwinski, arrived at MF Global's Chicago office around 9 p.m. By 11:00 p.m., neither the CME auditors nor MF Global staff were able to identify the accounting error. At 11:40 p.m., a CME Group audit-team member e-mailed his colleagues that Ms. Serwinski had told CME Group auditors that she would "look into coming up with additional funds to transfer into segregation as a contingency" if the accounting error was identified.

In an interview with Subcommittee staff, Ms. Serwinski explained that on that Sunday evening, Ms. O'Brien had told her that the shortfall in customer segregated funds was real, rather than an accounting error. Ms. O'Brien provided Serwinski a document that showed the deficiency to be the result of three types of transactions: (1) intra-day loans between MF Global's futures commission merchant and its broker-dealer; (2) the funding of outgoing broker dealer client funds; and (3) a \$175 million transfer to MF Global's London office on October 28. Together, these transactions totaled \$909 million.

Monday, October 31, 2011

At 1:00 a.m., Ms. O'Brien and Ms. Serwinski informed the CME Group that there was in fact a deficiency in segregated customer funds. At approximately 2:00 a.m., MF Global's senior management, including Ms. Ferber and Mr. Steenkamp, informed regulators of the shortfall in segregated customer funds in a conference call. MF Global's pending deal with Interactive Brokers to purchase the firm was called off, and MF Global continued to search for liquidity. At 6:25 a.m., Christine Serwinski circulated a schedule of available assets to Henri Steenkamp. The document listed an excess in the broker-dealer customer reserve account of approximately \$220 million. According to staff interviews with staff from the SEC's Division of Trading and Markets, the SEC expressed concern to MF Global regarding the firm's calculation of excess funds in the broker-dealer customer reserve account and cautioned MF Global against transferring these funds. Notwithstanding the SEC's admonition, MF Global transferred the funds. Ms. Serwinski also requested a transfer of funds from MF Global's U.K. subsidiary on Monday morning, but the U.K. financial regulator had frozen the subsidiary's accounts. MF Global continued to sell its RTM portfolio and other assets.

Update from the SIPA Trustee

Since the Subcommittee's last MF Global hearing on February 2, 2012, James Giddens—the trustee for the SIPA Liquidation of MF Global Inc.—has released updates on his investigation and the shortfall in MF Global's segregated customer funds. On February 6, 2012, Mr. Giddens filed a Preliminary Report on the status of his investigation with the bankruptcy court.³ According to the trustee's report, an unprecedented number of cash and securities transactions took place in the firm's final week of operations. Cash transactions into and out of MF Global totaled more than \$105 billion, and securities transactions—including the liquidation of customer securities, proprietary positions, and other items—totaled more than \$100 billion. The Preliminary Report states that MF Global had a shortfall in its customer segregated funds beginning on Wednesday, October 26, 2011, and that the shortfall continued to grow until MF Global filed for bankruptcy on October 31. On February 10, 2012, Mr. Giddens released a revised estimate of the amount of missing customer funds: the estimated shortfall is now \$1.6 billion, up from the \$1.2 billion estimate from November 2011.