STAFF REPORT

PREPARED FOR

REP. RANDY NEUGEBAUER, CHAIRMAN
SUBCOMMITTEE ON OVERSIGHT & INVESTIGATIONS
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"The goal here is not to be a prop trader. … I don't think that we will be in a risk-taking position, substantial enough to have it be the kind of thing that the rating agencies would say 'holy cow, these guys got a different business strategy' than what we told them we had."

-Jon Corzine, May 20, 2010

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Preface

On October 31, 2011, MF Global Holdings Ltd. (MF Global) filed for bankruptcy under Chapter 11 of the U.S. Bankruptcy Code. On the same day, the Securities Investor Protection Corporation began liquidation proceedings for MF Global's U.S.-based subsidiary, MF Global, Inc. (MFGI), and the U.S District Court appointed a trustee to handle the company's liquidation. Although initial reports estimated that $700 million in customer funds required to be housed in separate accounts for safekeeping were missing, it is now known that MF Global's collapse resulted in a $1.6 billion shortfall in customer funds.

At the time of MF Global's bankruptcy, the company served approximately 36,000 futures customers and 318 securities customers. While MF Global's customers numbered in the thousands, simply totaling up the number of customers significantly understates how many individuals were affected by the shortfall of customer funds: some of the individual futures customers were farm co-operatives representing up to 35,000 farmers.

MF Global had a 230-year lineage as a commodities broker. In addition to being a futures commission merchant, MFGI was also a securities broker-dealer. In its Fiscal Year 2011 10-K report, MF Global described itself as "one of the world's leading brokers in markets for commodities."

But, despite its long history, MF Global was a troubled company. In the four years before it went bankrupt, MF Global saw its credit rating downgraded repeatedly and it suffered chronic multi-million dollar losses. The company's final quarterly earnings statement filed October 25, 2011 reported a loss of $119 million. MF Global also experienced repeated

compliance failures. Beginning in 1997, the Commodity Futures Trading Commission (CFTC), the CME Group, and other exchanges through which the company traded took 80 regulatory actions against the company. On December 17, 2009, the CFTC fined MF Global $10 million for supervision failures in four separate instances between 2003 and 2008, which included unauthorized trading by an MF Global employee that led to a $141.5 million loss.

During the last 19 months of the company's operations, former U.S. senator and governor of New Jersey and one-time Chairman of Goldman Sachs, Jon Corzine, served as MF Global's Chairman and Chief Executive Officer. Shortly after arriving at the company in March 2010, Corzine announced his strategic plan to restore MF Global's profitability by turning the company into a global investment bank (a "mini-Goldman") and securing a primary dealer designation for MFGI from the Federal Reserve Bank of New York (New York Fed). MF Global also sought to generate revenue by purchasing European sovereign bonds and using them as collateral in repurchase-to-maturity (RTM) transactions, investments which were a prime focus of Corzine's attention.

Beginning in September 2010, MF Global significantly expanded its European RTM portfolio to support the company's new business model and to boost profits. Under Corzine's direction, MF Global's net position in European sovereign debt increased to $6.3 billion just weeks before the company's collapse. Ultimately, MF Global's belated disclosure of its extensive European RTM portfolio, its inability to meet increasing liquidity demands, and its lack of internal controls led to its collapse.

According to MFGI's bankruptcy trustee, nearly all of MFGI's securities customers have seen 60% or more of their account value returned and 194 securities claims have been satisfied in

total. The bankruptcy trustee and the administrators for MF Global's United Kingdom subsidiary, MF Global UK Limited (MFGUK) now dispute whether an additional $640 million of MFGI commodities customers' funds – which were deposited by MFGI in an MFGUK account to support trading on foreign exchanges – should be returned to MFGI customers or be used to satisfy claims of other MFGUK creditors. This dispute will be litigated at a trial scheduled to begin on April 9, 2013, in the United Kingdom.

The Subcommittee's Investigation

The Subcommittee on Oversight and Investigations of the House Committee on Financial Services Majority Staff (Subcommittee) undertook this investigation for three reasons: first, MF Global's customers deserve to know how and why their funds went missing; second, market participants deserve to know whether regulatory lapses have been identified and corrected; and third, taxpayers deserve to know that regulators have been held accountable so that similar losses may be prevented from occurring in the future.

Over the course of its yearlong investigation, the Subcommittee conducted over fifty interviews and held three hearings at which it considered the testimony of nineteen witnesses, including MF Global's former senior managers and its principal regulators. Additionally, the Subcommittee examined more than 243,000 documents produced by MF Global, the company's federal commodities and securities regulators, the company's independent auditor, credit rating agencies, the New York Fed, the self-regulatory organizations, exchanges, and clearing houses to which the company belonged. The findings and recommendations contained in this report rely primarily upon the information obtained from these interviews, hearings, and source documents.

This report addresses issues falling within the jurisdiction of the House Committee on Financial Services. Accordingly, the Subcommittee has not conducted a forensic examination of MF Global's accounting practices, nor has it assessed the potential civil or criminal liability of the company and its former employees. Such judgments are the proper province of the Trustee for the liquidation of MFGI and law enforcement and regulatory agencies.

MF Global Prior to Jon Corzine's Arrival

Company Origin and Growth

MF Global traces its origin back 229 years to a sugar brokerage business founded by James Man in London in 1783. In 1869, the business became known as E.D.&F. Man. It set up its first overseas operations in New York and Hong Kong in 1972, and began trading commodities futures. The company expanded its services in 1983 to include investment management, and by 1994, when it first listed on the London Stock Exchange, it had $1 billion in funds under management.[1]

In 2000, E.D.&F. Man spun off its agricultural commodities business and changed its name to Man Group plc.[2] Under the leadership of Kevin R. Davis, who joined the company in 1991 and rose to become the Chief Executive Officer (CEO) of Man Financial (Man Group's global brokerage businesses), the company sought to capitalize on the rapid growth in global derivatives markets by acquiring businesses offering new products, including futures, options, and other derivatives.[3] Man Group acquired 17 companies in 18 years, including GNI Holdings Ltd. in 2002 and Refco Inc. in 2005.[4] GNI was a leading European broker of futures and options, foreign exchange, and equity derivative products, and its acquisition established the Man Group, through Man Financial, as the world's largest independent futures broker.[5] Refco

[1] Man website, http://www.mangroupplc.com/about-man/heritage/index.jsf (last visited July 19, 2012).
[2] *Id.*
[3] From 2001-2007, the compound annual growth rates in contract volumes in exchange-traded and over-the-counter derivates were 22% and 32%, respectively. Form 10-K for MF Global Holdings Ltd. (fiscal year ended Mar. 31, 2008) at 12-13 (citing Bank for International Settlements Quarterly Review) [hereinafter FY08 10-K].
[4] MF Global IPO Prospectus [hereinafter IPO Prospectus], at 122 and 49.
[5] *Man Group Acquires Derivative Brokerage GNI*, INVESTORS OFFSHORE, Oct. 24, 2002, (http://www.tax-news.com/news/Man_Group_Acquires_Derivatives_Brokerage_GNI____9774.html) (last visited Nov. 14, 2012).

was a regulated futures brokerage with client accounts and assets in the U.S., Singapore, Canada, and India, and its acquisition further expanded Man Financial's global brokerage services.[6]

Following these acquisitions, and fueled by the growth of the derivatives industry, Man Financial became one of the leading brokers of exchange-listed futures and options in the world, providing execution and clearing services for exchange-traded and over-the-counter derivative products, as well as for non-derivative products and securities in the cash market.[7] The company served more than 130,000 active client accounts, and held leading market share on the biggest exchanges in North America and Europe, including the Chicago Mercantile Exchange (CME), CBOT, the New York Mercantile Exchange, and Eurex.[8] The company also had a global footprint, with 34 offices in cities such as New York, Chicago, London, Paris, Mumbai, Hong Kong, Singapore, and Sydney.[9] Man Financial more than doubled its exchange-traded brokerage volume between 2004 and 2007, increasing both revenues and operating margins, and reported net income of $188 million on revenue of $5.7 billion for the fiscal year ending March 31, 2007.[10]

The Man Group Spins Off MF Global

In 2007, Man Group decided to separate its brokerage businesses from its asset management businesses and announced that it would spin off Man Financial into an independent, Bermuda-incorporated company named MF Global.[11] In order to finance the spinoff, MF Global

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[6] IPO Prospectus, *supra* note 4, at 2 and 122; FY08 10-K, *supra* note 3, at 138, note 19; Standard & Poor's Rating Services [hereinafter S&P] Ratings Outlook for MF Global, July 13, 2007 [hereinafter S&P July 2007 Ratings], at 4.
[7] IPO Prospectus, *supra* note 4, at 1.
[8] *Id*. The Chicago Mercantile Exchange and the Chicago Board of Trade officially merged to form the CME Group Inc. on July 12, 2007. http://www.cmegroup.com/company/history/magazine/Summer2007/FromWaterStreetToTheWorld.html (last visited Sept. 25, 2012).
[9] IPO Prospectus, *supra* note 4, at 1; S&P July 2007 Ratings, *supra* note 6, at 3.
[10] Form 10-K for MF Global Holdings Ltd. (fiscal year ended Mar. 31, 2007).
[11] Jacob Bunge, *MF Global: History From IPO to Bankruptcy*, WALL ST. J., Oct. 31, 2011 (http://blogs.wsj.com/deals/2011/10/31/mf-global-history-from-ipo-to-bankruptcy/) (last visited Oct. 3, 2012).

entered into a $1.4 billion unsecured committed revolving credit facility (bridge loan) with several institutions, the net proceeds of which the new company would use to repay its obligations to Man Group and third parties.[12] On July 18, 2007, MF Global announced an initial public offering (IPO) of 97.38 million shares that would trade on the New York Stock Exchange (NYSE) under the ticker symbol "MF."[13] The offering, which was priced at $30 per share, generated $2.92 billion in capital, making it the second-largest NYSE-listed IPO of 2007.[14] Although share prices fell 15% in the first week of trading, they recovered by the end of the year to close at $31.47, with a corresponding market cap of nearly $3.8 billion.[15]

Unauthorized Trading Incident Shatters Investor Confidence

During the early morning hours of February 27, 2008, Evan Dooley, a registered trader in MF Global's Memphis office, began placing orders on wheat futures for his personal account through a home computer linked to the company's proprietary system.[16] Dooley accumulated a net short position in wheat futures totaling over 16,000 contracts, well in excess of his trading limits.[17] MF Global did not discover Dooley's trades until the price of wheat had increased,

[12] IPO Prospectus, *supra* note 4, at 51. Although MF Global planned to replace its bridge loan with debt offerings following its IPO, market conditions frustrated the company's efforts to do so. Instead, MF Global renegotiated its bridge loan with existing lenders to extend the loan maturity to Dec. 12, 2008 in exchange for paying higher interest rates on the $1.05 billion balance.
[13] IPO Prospectus, *supra* note 4.
[14] Form 10-Q for MF Global Holdings Ltd. (quarterly period ended Sept. 30, 2007) [hereinafter FY08 Q2 10-Q], at 13.
[15] MF Global Holdings Ltd. (MFGLQ) Stock Chart, Yahoo Finance, Mar. 23, 2010 – Mar. 24, 2010 [hereinafter Mar. 23-24, 2010 MFG Stock Chart] http://finance.yahoo.com/echarts?s=MFGLQ+Interactive (last visited July 20, 2012).
[16] Form 10-K for MF Global Holdings Ltd. (fiscal year ended Mar. 31, 2010) [hereinafter FY10 10-K], at 35; Press Release, U.S. Commodities Futures Trading Commission [hereinafter CFTC], CFTC Sanctions MF Global Inc. $10 Million for Significant Supervision Violations between 2003 and 2008 (Dec. 17, 2009), *available at* http://www.cftc.gov/PressRoom/PressReleases/pr5763-09 (last visited Oct. 15, 2012).
[17] Form 8-K for MF Global Ltd. (Feb. 27, 2008).

resulting in a loss of $141.5 million.[18] As a clearing member of the exchange through which Dooley had traded, MF Global was obligated to cover Dooley's losses.[19]

When the company announced the unauthorized trading the following day, share prices fell nearly 28% to close at $21.29.[20] On February 29, 2008, Fitch Ratings (Fitch) put MF Global on negative watch, citing deficiencies in its risk-management system, and Standard & Poor's (S&P) downgraded the company's credit rating to BBB with a "CreditWatch Negative" placement, indicating that it could lower the rating further based on its review of the company's risk management policies.[21] On March 17, rumors of a liquidity crisis at the company sent share prices as low as $3.64 a share, prompting the CFTC to issue a statement indicating that "MF Global is currently in compliance with the agency's regulatory financial requirements."[22] The CME Group also issued a statement reflecting that "all clearing members, including MF Global … remain in good standing and continue to meet all of their obligations to the clearing house."[23] Although these statements helped stabilize MF Global's share price that day, the company's stock closed at $6.05, marking a 79% decrease in value in just three weeks.[24] Dooley's rogue trading and the resulting loss had shattered investor confidence in the company.

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[18] *Id.*
[19] *Id.*
[20] Mar. 23-24, 2010 MFG Stock Chart, *supra* note 15.
[21] Letter from Craig Parmelee, Managing Dir. and Lead Analytical Manager for North American Fin. Institutions Ratings, S&P, to Randy Neugebauer, Chairman, Subcomm. on Oversight and Investigations [hereinafter O&I Subcomm.] (Jan. 17, 2012) at 3. [hereinafter S&P Jan. 17, 2012 letter]; Jennifer Yousfi, *Unauthorized Trades Cost MF Global $141.5 Million*, MONEY MORNING¸ Feb. 29. 2008 (http://moneymorning.com/2008/02/29/unauthorized-trades-cost-mf-global-1415-million/) (last visited Oct. 15, 2012).
[22] Press Release, CFTC, Statement on MF Global (Mar. 17, 2008) http://www.cftc.gov/PressRoom/PressReleases/cftcmfglobalstatement031708 (last visited Sept. 25, 2012).
[23] Press Release, CME Group, Statement on MF Global in Good Standing at CME Clearing (Mar. 17, 2008) http://cmegroup.mediaroom.com/index.php?s=43&item=708&pagetemplate=article (last visited Sept. 25, 2012).
[24] Mar. 23-24, 2010 MFG Stock Chart, *supra* note 15.

Efforts to Restore Investor Confidence Falter

In the aftermath of Dooley's unauthorized trading, MF Global was leveraged at almost 39-to-1, with $18.6 billion of its operating capital coming from short-term repurchase agreements, and would soon announce quarterly and fiscal year-end losses.[25] The company needed capital to repay the bridge loan maturing in December and sought ways to strengthen its capital structure. On May 20, 2008, MF Global announced that it entered into an agreement with a private equity fund controlled by J.C. Flowers & Co. LLC, in which the fund, J.C. Flowers II L.P., agreed to provide a backstop commitment of $300 million toward the sale of equity-linked securities.[26] MF Global planned to use the proceeds from the sale to repay a portion of its bridge loan.[27] Under the terms of the commitment, J.C. Flowers II L.P. would purchase a minimum of $150 million and a maximum of $300 million of perpetual convertible preferred shares.[28] Each preferred share paid a 6% annual dividend and was convertible at any time to common stock at an initial conversion price of $12.50 per share.[29] J.C. Flowers II L.P. also had the right to appoint up to two directors to MF Global's board of directors.[30]

At the time, M.F. Global's investors and its board welcomed the investment. J.C. Flowers & Co.'s managing director, J. Christopher Flowers, had a positive reputation on Wall Street.[31] Flowers had made partner at Goldman Sachs at the age of 30, and eventually headed

[25] FY08 10-K, *supra* note 3.
[26] Press Release, MF Global, MF Global Reports Record Fourth Quarter and Fiscal Year 2008 Results (May 20, 2008), at 2 http://www.sec.gov/Archives/edgar/data/1401106/000119312508118826/dex991.htm (last visited Sept. 25, 2012).
[27] *Id.*
[28] *Id.*
[29] *Id.* As a result of the issuance of additional convertible preferred shares on June 20, 2008, MF Global paid J.C. Flowers a make-whole payment of 26.7 million and increased the dividend rate on its existing preferred shares to 10.725%.
[30] *Id.*
[31] *Id.*

the investment bank's financial services deals business.[32] Leaving Goldman in 1998, Flowers went on to orchestrate the buy-out of Long-Term Credit Bank of Japan — the first time foreigners had bought a Japanese bank — and then founded and managed several private equity funds.[33]

The J.C. Flowers deal appeared to momentarily calm investors. In June 2008, MF Global was able to enter into a five-year, $1.5 billion committed unsecured revolving credit facility (liquidity facility) with a syndicate of banks.[34] The company used proceeds from this liquidity facility to pay down $350 million of its bridge loan.[35] On June 18, the company announced that it would issue $150 million of convertible preferred shares and $150 million of convertible senior notes in two private offerings and use the proceeds to further pay down its bridge loan.[36]

However, in the press release announcing the offering, MF Global also disclosed for the first time that "the narrowing of short term credit spreads has had a negative impact on net interest income and overall pre-tax margins."[37] This news, which pertained to a major source of the company's revenue, renewed panic among investors and prompted Moody's Investor Service (Moody's) to assign MF Global's credit rating a negative outlook.[38] On June 18, the day of the announcement, the company's stock fell more than 43%, to close at $7.83 a share, erasing nearly

[32] Ryan Dezember, *Private-Equity Investor J.C. Flowers Could Lose Nearly $48 million on MF*, WALL ST. J., Nov. 1, 2011 (http://online.wsj.com/article/SB10001424052970204394804577010181017063466.html).
[33] *Id.*
[34] Form 10-Q for MF Global Ltd. (quarterly period ended June 30, 2009), at 16-17. JP Morgan [hereinafter JPMC] and Bank of New York Mellon were the primary lenders.
[35] Form 10-K for MF Global Holdings Ltd. (fiscal year ended Mar. 31, 2009) at 78 [hereinafter FY09 10-K].
[36] Press Release, MF Global, MF Global to Offer $150 million of Convertible Preference Shares and $150 Million of Convertible Senior Notes (June 17, 2008) http://www.sec.gov/Archives/edgar/data/1401106/000119312508135379/dex991.htm (last visited Sept. 25, 2012).
[37] *Id.*
[38] Ratings Action, Moody's Investors Service [hereinafter Moody's] confirms MF Global's Baa1 rating; assigns negative outlook, June 18, 2008.

all of the previous three months' gains.[39] The Wall Street Journal noted that the announcement "left analysts and investors yearning for more information."[40]

MF Global continued to seek sources of capital and restore investor confidence throughout June and July 2008. It sold its previously-announced convertible preferred shares and senior notes on June 20, albeit with higher than anticipated annual dividend rates, reflecting the higher risk premium demanded by the market.[41] On July 18, the company sold an additional $150 million of convertible preferred shares to J.C. Flowers II L.P. paying an annual dividend of 9.75%, which it used to repay more of the bridge loan.[42] Also on July 18, the company entered into a credit agreement with several banks that provided for a two-year, $300 million unsecured term loan facility, which would enable it to repay the remaining balance on its bridge loan.[43] Finally, MF Global announced on July 29 that it had appointed David I. Schamis to its board and that he would serve on the company's audit committee.[44] J. Christopher Flowers had nominated Schamis, a managing director J.C. Flowers & Co. L.L.C., using the authority granted to J.C. Flowers II L.P. to appoint up to two directors under its investment agreement with MF Global.[45] Despite these efforts, the company's stock continued its precipitous fall, closing at just $4.34 on September 30, with a corresponding market cap of only $522.1 million.[46]

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[39] Mar. 23-24, 2010 MFG Stock Chart, *supra* note 15.
[40] *MF Global Tries to Temper Selloff*, WALL ST. J. (June 18, 2008).
[41] Form 8-K for MF Global Ltd. (June 20, 2008).
[42] Form 8-K for MF Global Ltd. (July 18, 2008).
[43] *Id.*
[44] Form 8-K for MF Global Ltd. (July 29, 2008).
[45] Investment Agreement between MF Global Ltd. and J.C. Flowers II L.P. (May 20, 2008), at 21, *available at* http://www.sec.gov/Archives/edgar/data/1401106/000119312508133184/dex1048.htm (last visited Oct. 15, 2012).
[46] O&I Subcomm. staff analysis of data obtained from MF Global's 10-K and 10-Q filings [hereinafter MF Global Fin. Performance]; O&I Subcomm. staff analysis of data obtained from historic share price data obtained from Yahoo Fin. [hereinafter MF Global Stock Prices].

A New Strategy Stalls

With the company's efforts to restore investor confidence faltering, MF Global's board of directors sought a change in the company's leadership. On October 28, 2008, the company announced that its board had appointed Bernard W. Dan, the former President and CEO of the Chicago Board of Trade (CBOT), as CEO to replace the long-serving Kevin Davis.[47] Investors reacted favorably to Dan's appointment; the company's stock rallied 80% in the week following the announcement.[48] Dan immediately sought to further boost investor confidence by embarking upon a new strategy: in December, MF Global contacted the New York Fed to express interest in its U.S.-based subsidiary, MFGI, being designated as a "primary dealer."[49]

Primary dealers act as counterparties to open market operations executed by the New York Fed in furtherance of U.S. monetary policy as determined by the Federal Open Market Committee.[50] To be eligible for consideration as a primary dealer, a company must meet minimum capital standards and have the capacity to make markets for the New York Fed, regularly participate in treasury auctions, and provide market commentary and information and analysis.[51] Because of these requirements, the New York Fed historically has tended to select larger, well-established, and well-known financial institutions.[52] Over time, market watchers

[47] Form 8-K for MF Global Ltd. (Oct. 28, 2008); Press Release, MF Global, MF Global Appoints Bernard W. Dan as Chief Executive Officer (Oct. 28, 2008).
[48] MF Global Stock Prices, *supra* note 46.
[49] E-mail from Donald Galante, Senior V.P., MF Global Inc., to Debby Perelmuter, Senior V.P., Markets Group, Federal Reserve Bank of N.Y. [hereinafter NYFRB] (Dec. 19, 2008, 03:34 p.m.).
[50] NYFRB Operating Policy Administration of Relationship with Primary Dealers Jan. 11, 2010 http://www.newyorkfed.org/markets/pridealers_policies.html (last visited Sept. 25, 2012) [hereinafter NYFRB New Primary Dealer Policy]; *Hearing on the Collapse of MF Global Before the Subcomm. on Oversight and Investigations of the House Comm. on Fin. Services*, 112th Cong. 93 (2011) [hereinafter Dec. 15, 2011 Hearing] (statement of Thomas C. Baxter, Jr., Gen. Counsel, NYFRB).
[51] *Id.*
[52] NYFRB Primary Dealers List http://www.newyorkfed.org/markets/pridealers_current.html (last visited Sept. 25, 2012).

have come to regard a primary dealer designation as a "Good Housekeeping' seal of approval," enhancing the company's standing in the marketplace.[53]

By securing a primary dealer designation from the New York Fed for MFGI, MF Global hoped to capitalize on what it believed that market watchers would perceive as its enhanced franchise value — a value that could translate into new business lines and new customers. However, the company's strategy immediately ran into three problems. Two of the issues involved the company's incorporation in Bermuda. First, the Primary Dealers Act of 1988 prohibited the New York Fed from designating a subsidiary of a foreign-owned company as a primary dealer unless the country in which the parent was domiciled provided the same opportunities to U.S. companies as it did to domestic firms in the underwriting and distribution of government debt.[54] Because the New York Fed had not previously determined whether Bermuda met this requirement, it would have to study the country before it could designate MF Global's subsidiary as a primary dealer. This process would take time and had an uncertain outcome. Secondly, there were reputational concerns associated with Bermuda's well-known

[53] The New York Fed took steps to eliminate this perception, specifically warning that primary dealer designation neither constitutes an endorsement of the company nor a replacement for prudent counterparty risk management and due diligence, NYFRB New Primary Dealer Policy, *supra* note 50, and going so far as to eliminate its surveillance activities over primary dealers in 1992, stating that the action "should be viewed merely as confirmation of the long-standing reality that the Bank does not have – nor has it ever had – formal regulatory authority over the Government securities market or authority over the primary dealers in their capacity as such." NYFRB Operating Policy Administration of Relationship with Primary Dealers, Jan. 22, 1992, http://www.newyorkfed.org/markets/pridealers_policies_920122.html (last visited September 25, 2012) ; Letter from Thomas C. Baxter, Jr. Gen. Counsel, NYFRB, to Randy Neugebauer, Chairman, O&I Subcomm. at 6 (June 22, 2012); Dec. 15, 2011 Hearing, *supra* note 50, at 3 (testimony of Thomas C. Baxter, Jr., Gen. Counsel, NYFRB). Nevertheless, the perception remained.

[54] *See* 22 U.S.C. §§5341-5342.

status as a tax haven.[55] When the New York Fed communicated this information to MF Global, the company indicated that it was considering switching jurisdictions.[56]

MF Global faced a third problem as well. In April 2009, the New York Fed contacted the CFTC and learned that MF Global was the subject of an investigation regarding the Dooley incident and one other matter.[57] In late April, the New York Fed informed MF Global that it had suspended consideration of MFGI's application pending resolution of the CFTC's investigation.[58] During this suspension period, MF Global executives tried to engage the New York Fed regarding the application, but were rebuffed and cautioned not to publicize its aspirations to be a primary dealer.[59] Concerned about, among other things, the public perception of designating any company as a primary dealer soon after regulatory action had been taken against the company, the New York Fed considered revising its primary dealer policy to institute a "cooling off" period beginning at the announcement of an enforcement action by a regulatory agency.[60]

On December 17, 2009, the CFTC issued its order against MF Global, citing the company for "risk supervision failures in four separate instances between 2003 and 2008,"

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[55] E-mail from Debby Perelmuter, Senior V.P., Markets Groups, FRBNY, to Jennifer Wolgemuth, Counsel & Ass't V.P., NYFRB, et al. (Apr. 1, 2009, 8:45 a.m.) [hereinafter Perelmuter E-mail]; *see also* Large U.S. Corporations and Federal Contractors with Subsidiaries in Jurisdictions Listed as Tax Havens or Financial Privacy Jurisdictions, GAO-09-157 (Dec. 18, 2008) http://www.gao.gov/assets/290/284522.pdf (last visited Sept. 25, 2012).

[56] Perelmuter E-mail, *supra* note 55. MF Global later confirmed that it would be switching jurisdictions, and reincorporated in Delaware on Jan. 4, 2010. E-mail from Perelmuter to Wolgemuth, et al. (June 11, 2009, 03:57 p.m.); E-mail from Perelmuter, to Wolgemuth, et al (June 30, 2009, 03:37 p.m.); FY10 10-K, supra note 16, at 1, 34, 44.

[57] E-mail from Wolgemuth, to Richard Dzina, Market Operations Monitoring and Analysis, Markets Group, NYFRB, et al. (Apr. 30, 2009, 02:42 p.m.).

[58] Dec. 15, 2011 Hearing, *supra* note 50, at 6 *(*testimony of Thomas C. Baxter, Jr., Gen. Counsel, NYFRB); E-mail from Wolgemuth, to Dzina, et al. (Apr. 30, 2009, 02:42 p.m.); E-mail from Perelmuter, to Wolgemuth, Dzina, et al. (Apr. 30, 2009, 02:57 p.m.).

[59] E-mail from Michael Silva, Chief of Staff, FRBNY, to Laurie Ferber, Gen. Counsel, MF Global (July 30, 2009, 05:38 p.m.); E-mail from Dzina, to Perelmuter (July 31, 2009, 07:04 p.m.); E-mail from Wolgemuth, to Dzina (Oct. 13, 2009, 06:17 p.m.).

[60] E-mail from Wolgemuth, to Thomas Baxter, Gen. Counsel, NYFRB (Sept. 1, 2009, 12:26 p.m.); E-mail from Joshua Frost, NYFRB, to Dzina (Oct. 12, 2009, 6:17 p.m.).

including the Dooley incident, and directing it to pay a $10 million fine and hire an outside consultant to review its risk management, supervision, and compliance programs.[61] The same day, MF Global contacted the New York Fed to express the company's eagerness to "re-engage" regarding MFGI's primary dealer application.[62] On January 11, 2010, the New York Fed released its revised primary dealer policy.[63] The revised policy required a two part application, established a formal application review procedure, and specified that the New York Fed would 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 [it] determines material or otherwise relevant to the potential primary dealer relationship."[64] MFGI formally submitted the first part of its primary dealer application on January 13, 2010, and submitted the second part on January 22.[65] In accordance with its new policy, the New York Fed determined that the CFTC order was material, and on January 26 informed MF Global that MFGI could not be named a primary dealer before December 17, 2010 (one year following the date of the CFTC order).[66]

The following day, Dan sent a letter to the New York Fed laying out MF Global's case for why a one-year delay would be unfair, asking the New York Fed to exercise its discretion to name MFGI a primary dealer before the expiration of the one-year period, and requesting a

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[61] Press Release, CFTC, CFTC Sanctions MF Global, Inc. $10 Million for Significant Supervision Violations between 2003 and 2008 (Dec. 17, 2009) http://www.cftc.gov/PressRoom/PressReleases/pr5763-09 (last visited Sept. 25, 2012); In the Matter of MF Global, Inc., CFTC Docket No. 10-03 http://www.cftc.gov/ucm/groups/public/@lrenforcementactions/documents/legalpleading/enfmfglobalorder12172009.pdf (last visited Sept. 25, 2012).

[62] E-mail from Peter McCarthy, Exec. V.P., Global Head of Fixed Income, MF Global, to Dzina (Dec. 17, 2009, 03:58 p.m.).

[63] Press Release, NYFRB, New York Fed Publishes Revised Policy for Administration of Primary Dealer Relationships (Jan. 11, 2010) http://www.newyorkfed.org/newsevents/news/markets/2010/ma100111.html (last visited Oct. 15, 2012).

[64] NYFRB New Primary Dealer Policy, *supra* note 50.

[65] NYFRB Memorandum, Chronology of FRBNY's Actions Relating to MF Global (Dec. 13, 2011), at 14, 15 [hereinafter NYFRB Chron].

[66] *Id*. at 15.

meeting to discuss the matter.[67] At the meeting on February 23, 2010, MF Global executives expressed concern about the length of time MFGI had been under consideration as a primary dealer and about the New York Fed's revised policy, which could further delay its designation.[68] New York Fed staff members reiterated that they had evaluated MFGI's application in accordance with the bank's revised primary dealer policy and that the company could not be designated as a primary dealer until after December 2010.[69] The New York Fed's decision thus stalled MF Global's primary dealer strategy — a strategy that the company had been pursuing since December 2008 — for at least another eleven months.

A Flawed Business Model Revealed

Unlike many of its competitors, MF Global was not affiliated with a larger financial institution, nor did it generally engage in non-brokerage businesses such as investment banking, asset management, or principal investment activity, including proprietary trading.[70] As an independent futures and options broker, MF Global generated most of its income from four sources: commissions from executing client orders on an agency basis; commissions from clearing services; mark-ups from client trades executed on a matched-principal basis; and interest income earned on cash and margin balances in client accounts as well as interest related to fixed income activities.[71] Accordingly, MF Global suffered from a fundamental flaw in its business model: because the company had not diversified its sources of revenue, it was vulnerable to a prolonged economic downturn affecting its areas of core profitability.

By the time MF Global learned that its primary dealer strategy had stalled, the financial crisis of 2008 had deepened into a global economic downturn which depressed both derivatives

[67] *Id.*
[68] E-mail from James P. Bergin, NYFRB, to Wolgemuth (Feb. 24, 2010, 04:41p.m.).
[69] *Id.*
[70] FY08 10-K, *supra* note 3, at 4, 10.
[71] *Id.*

trading volume and interest rates and choked off MF Global's income. At the CME, average trading volume fell 20 percent and the total notional value of contracts traded on its exchanges fell by a third.[72] Additionally, monetary actions taken by several countries also resulted in ultra-low interest rates around the world.[73] In the United States, for example, the Federal Reserve System's Federal Open Market Committee reduced the target federal funds rate from 4.75 percent in 2007 to 0 to .25 percent by the end of 2008.[74]

MF Global's revenues collapsed in response to these developments. For fiscal years 2009 and 2010, the total volume of exchange-traded futures and options transactions that MF Global executed and cleared fell by 20 percent.[75] With fewer derivatives orders to execute and clear, MF Global's annual net commission revenue fell by 32 percent over the same time period (from $796 million to $544 million).[76] Additionally, the interest rate spreads that MF Global could realize by reinvesting client cash and margin balances shrunk significantly, resulting in declining interest revenue.[77] Over the five fiscal quarters between October 1, 2007, and December 31, 2008, for instance, MF Global's gross interest revenue decreased by 87 percent, from $1.26 billion to just $154 million.[78]

Credit rating agencies took notice of MF Global's shrinking revenues. On December 4, 2008, S&P changed the company's BBB credit rating outlook to negative because of its lower

[72] Matt Koppenheffer, *J. Christopher Flowers: Corzine's Kingmaker*, THE MOTLEY FOOL, Dec. 16, 2011 (http://www.fool.com/investing/general/2011/12/16/j-christopher-flowers-corzines-kingmaker.aspx) (last visited Nov. 14, 2012) [hereinafter Koppenheffer article].
[73] Joellen Perry, *ECB Cuts Rates to 2%, Matching '05 Low*, WALL ST. J., Jan. 16, 2009 (http://online.wsj.com/article/SB123201496350385293.html) (last visited Nov. 14, 2012).
[74] FRBNY, Historical Changes of the Target Federal Funds and Discount Rates, http://www.newyorkfed.org/markets/statistics/dlyrates/fedrate.html (last visited Sept. 25, 2012).
[75] *See* FY09 10-K, *supra* note 35, at 50; FY10 10-K, *supra* note 16, at 44.
[76] *Cf.* FY09 10-K, *supra* note 35 to FY10 10-K, *supra* note 16.
[77] See FY10 10-K, *supra* note 16, at 18.
[78] FY08 Q2 10-Q, *supra* note 14; Form 10-Q for MF Global Ltd. (quarterly period ended Dec. 31, 2008).

cash flows and a decline in customer payables.[79] On January 16, 2009, Moody's downgraded MF Global's credit rating to Baa2 from Baa1, noting a "weakening in MF Global's earnings generation ability" and predicting that MF Global's "revenues [would] continue to come under pressure over the coming quarters."[80] On February 25, S&P affirmed its BBB rating and negative outlook, noting that it expected MF Global to continue to face "revenue challenges and elevated competitive pressures."[81] On September 24, S&P again affirmed its BBB rating and negative outlook, noting that it expected MF Global would continue to have lower trading volumes and reduced interest income, which would likely reduce its revenue over the coming quarters.[82] Finally, on November 6, 2009, Moody's noted a "sharp increase in MF Global's balance sheet leverage" and assigned a negative outlook to its Baa2 ratings.[83]

The End of an Era

By 2010, MF Global faced serious financial difficulties. The company's stock, which had once traded above $30 per share, now traded for under $10, representing a reduction in market capitalization of over $2 billion.[84] The Dooley trading incident shattered investor confidence in the company, and its efforts to restore confidence, including its application to become a primary dealer, had faltered and stalled. MF Global was highly leveraged at above 35-to-1, and it lacked diversified revenue streams with which to combat the effects of the global economic downturn.[85] Additionally, the company had lost money three years in a row, reporting

[79] S&P Jan. 17, 2012 letter, *supra* note 21, at 3.
[80] Letter from Steven R. Ross, Partner, Akin Gump Strauss Hauer & Feld, to Randy Neugebauer, Chairman, O&I Subcomm. (Jan. 17, 2012), at 2 [hereinafter Moody's Jan. 17, 2012 letter].
[81] Global Credit Portal: Ratings Direct, MF Global Ltd. research update, S&P, Feb. 25, 2009.
[82] S&P Jan. 17, 2012 letter, *supra* note 21, at 3.
[83] Moody's Jan. 17, 2012 letter, *supra* note 80, at 2.
[84] MF Global Fin. Performance, *supra* note 46. MF Global Stock Prices, *supra* note 46.
[85] MF Global Fin. Performance, *supra* note 46.

net losses of $69.54 million in fiscal year 2008, $48.61 million in fiscal year 2009, and $136.97 million in fiscal year 2010.[86]

On March 17, 2010, amid these financial difficulties, Bernard Dan resigned as CEO of MF Global, citing personal reasons.[87] His resignation came just 16 months into his term, and less than a month after the New York Fed delayed consideration of MFGI's primary dealer application. Dan's departure marked the end of an era for MF Global. The company's next Chairman and CEO would soon steer the company away from its roots as an independent futures and options broker and take the company in an entirely new direction.

[86] FY08 10-K, *supra* note 3; FY09 10-K *supra* note 35; FY10 10-K, *supra* note 16.
[87] Form 8-K for MF Global Ltd. (Mar. 23, 2010) [hereinafter Mar. 23, 2010 8-K]; Press Release, MF Global, MF Global Appoints Jon S. Corzine Chairman and Chief Executive Officer (Mar. 23, 2010) [hereinafter MF Global Mar. 23, 2010 Press Release] http://sec.gov/Archives/edgar/data/1401106/000119312510064637/dex991.htm (last visited Oct. 15, 2012).

The Jon Corzine Era

Corzine Appointed CEO of MF Global

MF Global's board moved quickly to replace Dan following his resignation. David Schamis immediately contacted J. Christopher Flowers to ask whether Jon Corzine would be interested in the position.[88] Securing an executive with Corzine's reputation and experience was viewed as a potential coup for MF Global. After a 23-year career at Goldman Sachs in which he rose from a bond trading desk to become the company's Chairman, Corzine served five years as a U.S. Senator and then four years as New Jersey's Governor.[89] The timing for approaching Corzine was opportune: Corzine had lost his gubernatorial reelection bid only months earlier. Additionally, Schamis knew that Flowers would be ideal to approach Corzine with MF Global's offer. In addition to Flowers' private equity fund investing in MF Global, Flowers and Corzine were good friends. Flowers and Corzine had worked together at Goldman Sachs, where Flowers had been instrumental in helping Corzine take Goldman Sachs public, and Flowers had later helped manage Corzine's blind trust after Corzine entered public service.[90] Additionally, Flowers had already been in contact with Corzine about the possibility of helping manage one of his company's private equity funds.[91]

Once Flowers approached Corzine with MF Global's offer, Corzine quickly accepted the position. On March 23, 2010, just six days after Dan's resignation, MF Global announced that Corzine would join the company as its Chairman and CEO. The company agreed to pay Corzine a $1.5 million salary and a $1.5 million signing bonus, and established a $3 million target

[88] Peter Elkind and Doris Burke, *The Last Days of MF Global*, CNN MONEY, June 4, 2012 (http://finance.fortune.cnn.com/2012/06/04/the-last-days-of-mf-global) (last visited Nov. 14, 2012) [hereinafter Elkind Burke article].
[89] Dec. 15, 2011 Hearing, *supra* note 50, at 127 (statement of Jon S. Corzine, CEO, MF Global).
[90] Koppenheffer article, *supra* note 72.
[91] *Id.*

performance bonus for the year.[92] At the same time, J.C. Flowers & Co. LLC announced that Corzine would become a partner in its third private equity fund in a lucrative deal that significantly enhanced the compensation package offered by MF Global.[93]

Investors reacted favorably to Corzine's appointment as MF Global's CEO. MF Global's stock price jumped more than 12 percent the day after the company announced his appointment, and continued to rise thereafter, increasing 33 percent within three weeks.[94] The credit rating agencies also viewed Corzine's appointment favorably. An S&P analyst wrote that the company "[was] more credible and [had] a better chance to get where it wants to go with Corizine [sic] as CEO."[95] Moody's discounted the abruptness of the transition between Corzine and Dan in light of "Mr. Corzine's decades of first-rate industry and leadership experience, as well as the reputational 'cache' [sic] and potential industry connections he would bring to MF Global."[96]

A New Environment for a Wall Street Veteran

MF Global was a new environment for Corzine. Although he had worked in the upper echelons of finance and politics, he had never worked in the futures industry, nor had he ever run a public company. The company's rapid expansion through acquisition had created nearly fifty direct or indirect subsidiaries located around the world, resulting in a disjointed corporate structure subject to supervision by multiple regulators with overlapping jurisdictions in multiple countries. As a holding company, MF Global derived 83 percent of its income from net revenue

[92] Mar. 23, 2010 8-K, *supra* note 87; MF Global Mar. 23, 2010 Press Release, *supra* note 87.
[93] J.C. Flowers & Co. offered Corzine a 3.5% carried interest in the fund's profits. *See* "Jon S. Corzine Contract with J.C. Flowers & Co. LLC" *and* "Jon S. Corzine Employment Agreement," accompanying Mar. 23, 2010 8-K, *supra* note 87.
[94] Mar. 23-24, 2010 MFG Stock Chart, *supra* note 15.
[95] S&P Rating Summary Record for MF Global Holdings Ltd. (Nov. 24, 2010), at 8.
[96] Press Release, Moody's, Moody's comments on MF Global's CEO change (Mar. 23, 2010) http://www.moodys.com/research/Moodys-comments-on-MF-Globals-CEO-change--PR_196823 (last visited Sept. 25, 2012).

generated by six regulated subsidiaries, five of which were located outside of the United States.[97] MFGUK, for instance, was authorized and regulated by the United Kingdom's Financial Services Authority, but also had branch offices in the Netherlands and France authorized under the European Union's "passport" system, as well as a representative office in Switzerland licensed by the Swiss Financial Market Supervisory Authority.[98] MF Global Canada Co. was registered with the Investment Industry Regulatory Organization of Canada as well as with each of the regional securities commissions in the Canadian provinces and territories in which it operated.[99] MF Global Singapore Pte. was licensed by the Monetary Authority of Singapore, but also had a branch office in Taiwan licensed by the Financial Supervisory Commission, Executive Yuan, Republic of China and registered with another Taiwanese authority, the Chinese National Futures Association.[100] MF Global Australia Limited was registered with the Australian Securities and Investment Commission and authorized by the New Zealand Securities Commission.[101] MF Global Hong Kong Limited was licensed by the Securities and Futures Commission.[102]

MF Global's sixth regulated subsidiary, MFGI, was based in the United States.[103] Unlike most other jurisdictions, the United States regulates the securities and futures industries separately.[104] Because MFGI had both securities and futures customers, it was registered as a

[97] MF Global, Presentation to the Securities and Exchange Commission [hereinafter SEC], at 17 (June 14, 2011) [hereinafter MF Global SEC Presentation]. The company derived 15 percent of its income from interest earned on held-to-maturity investments, with the remaining two percent coming from all other sources.
[98] *See* "Part II to the Application of MF Global Inc., a subsidiary of MF Global Holdings Ltd. to become a primary dealer," at 11 (Jan. 22, 2010) [hereinafter MFGI Primary Dealer App. Part II] http://www.newyorkfed.org/markets/MFG_part_II.PDF (last visited Sept. 25, 2012).
[99] *Id.*
[100] *Id.* at 12.
[101] *Id.*
[102] *Id.*
[103] Before Jan. 1, 2008, MF Global had conducted its U.S.-based securities and derivatives brokerage businesses through two separate legal entities. However, it merged these two entities on Dec. 31, 2007, and changed the name of the surviving entity to MF Global Inc. *See* MFGI Primary Dealer App. Part II, *supra* note 98, at 10.
[104] The Dept. of Treasury Blueprint for a Modernized Financial Regulatory Structure (Mar. 2008).

"broker-dealer" with the Securities and Exchange Commission (SEC) and as a "futures commission merchant" (FCM) with the CFTC.[105] As a registered broker-dealer, MFGI was also a member of the Financial Industry Regulatory Authority (FINRA), a self-regulatory organization (SRO) for the securities industry.[106] The Chicago Board Options Exchange (CBOE), another securities industry SRO, served as MFGI's "designated examining authority" for purposes of conducting yearly examinations of its finances and operations.[107] Similarly, as a registered FCM, the company was a member of the National Futures Association (NFA), a futures-industry SRO, and of all U.S. futures exchanges through which it cleared trades, including the CME Group, which served as its "designated self-regulatory organization." As such, the CME Group examined MFGI's records in accordance with protocols established by a group of futures-industry SROs, including examinations of MFGI's customer funds and its capital levels.

As a publicly-traded company, MF Global filed annual and quarterly reports with the SEC providing a comprehensive overview of the company's business and financial condition.[108] Because MFGI was also a broker-dealer and FCM, it was subject to the rules of the SEC and the CFTC that protect a registered company's customers, counterparties and creditors. Both the SEC and CFTC, for instance, have a "net capital" rule to ensure that registered companies have enough liquid assets on hand to pay off their liabilities quickly if they fail. Under both rules, a registered company must maintain a minimum level of "net capital," which, defined broadly, is the amount of current (liquid) assets the company holds in excess of its liabilities.[109] In

[105] Dec. 15, 2011 Hearing, *supra* note 50, at 107 (statement of Dan M. Berkovitz, Gen. Counsel, CFTC); *Id.* at 115 (statement of Robert Cook, Dir., Div. of Trading and Markets, SEC).
[106] *Id* at 52 (statement of Robert Cook, Dir., Div. of Trading and Markets, SEC).
[107] *Id.* at 56 (statement of Richard Ketchum, Pres., Chairman and CEO, FINRA).
[108] 17 C.F.R. §240.13a-1 (filing of annual report) *and* 17 C.F.R. §240.13a-13 (filing of quarterly report).
[109] 17 C.F.R. §240.15c3-1 (net capital requirements for broker dealers); 17 C.F.R. §1.17 (minimum financial requirements for futures commission merchants [hereinafter FCMs]).

calculating current assets, the rules impose "haircuts" on certain types of securities and futures, which are discounts from the present value of the assets to reflect the fact that they may have to be sold for less than market value in a rapid liquidation.[110]

Because MFGI was subject to oversight by both regulators, the company calculated its capital requirements according to both regimes, and complied with the higher capital requirement.[111] MFGI complied with the SEC's rule because, during the period in question, that rule provided a higher requirement than the CFTC's.[112] To ensure that it was properly capitalized, MFGI determined its level of net capital on a monthly basis and reported the amount to the SEC, the CFTC, and its SROs in a monthly report, known as the Financial and Operational Combined Uniform Single Report (FOCUS report).[113]

The SEC and CFTC each have separate rules governing the protection of customer property.[114] For securities customers, the SEC's "customer protection" rule requires a broker-dealer to maintain physical custody or control of all fully paid and excess margin customer securities and to segregate cash held on deposit in customer accounts to ensure that customer funds are not used as a source of capital for the company's operations.[115] To help ensure that a broker-dealer can readily return all customer property quickly in the event of failure, the broker-dealer must maintain a special reserve bank account holding an amount of cash or cash-

[110] *Id.* The haircut percentage to apply is set by rule and depends on the type of asset and its maturity date.
[111] *See, e.g.*, 17 C.F.R. §1.17(a)(1) (requiring FCMs to maintain capital equal to or in excess of the greatest of one of four measures, including the amount of net capital specified by SEC rule).
[112] Dec. 15, 2011 Hearing, *supra* note 50, at 118 (Statement of Robert Cook, Dir., Div. of Trading and Markets, SEC).
[113] 17 C.F.R. §240.17a-5 (requiring broker dealers to submit monthly reports); 17 C.F.R. §1.18 (allowing FCMs to submit FOCUS report in lieu of CFTC Form 1-FR in certain circumstances).
[114] 17 CFR 1.20 (establishing protections for customers trading on domestic futures exchanges), 30.7 (protections for customers trading on foreign futures exchanges), and 240.15c3-3 (protections for securities customers).
[115] 17 CFR §240.15c3-3.

equivalent securities greater than or equal to the amount of net obligations owed to customers as a result of daily trading activities.[116]

For futures customers, the CFTC had different "customer protection" rules for property held by an FCM for trading by customers on U.S. exchanges and property held for trading on foreign exchanges.[117] For customer property held for use on U.S. exchanges, an FCM must maintain a "segregated" account into which it deposits the property.[118] The balance of the segregated account must at all times be greater than or equal to the net liquidated value of all customer property.[119] An FCM may deposit its own funds into the segregated account as a cushion to prevent a shortfall of customer funds, but if it subsequently withdraws its funds from the account, the amount withdrawn cannot exceed the amount of this cushion.[120] For customer property held for use on foreign exchanges, an FCM must maintain a "secured" account that holds an amount that is greater than or equal to the "secured amount," which is defined as the aggregate amount of funds required to support each customer's open foreign futures and options positions, plus or minus gains or losses on those positions (the "Alternative Method").[121] Because the "secured amount" represents an FCM's minimum obligation under the rule, an

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[116] *Id.*

[117] *Cf.* Rule 1.20 and 30.7. Although the Commodity Exchange Act requires that FCMs segregate customer funds used for trading on U.S. exchanges, the Act does not expressly require FCMs to segregate funds used for trading on foreign exchanges. *See, e.g.*, 76 FR 78776, 78777 (2011). Instead, the Act grants the CFTC the discretion to write rules governing trading on foreign exchanges. *Id.* When it published the rules, the CFTC recognized that there were "inherent limitations on its ability to provide U.S. residents trading on foreign exchanges [with] identical protections available to U.S. contract markets" because those funds may become subject to foreign law governing the disposition of customer funds upon the insolvency of the customer's broker. *Id.*; *see also* Foreign Futures and Foreign Options Transactions, 52 Fed. Reg. 28,980, at 28,984-85 (Aug. 5, 1987) (to be codified at 17 C.F.R. pts. 1, 30, 32, and 166) [hereinafter Foreign Futures and Options Rulemaking]; Interview by O&I Subcomm. staff with CFTC personnel, in Wash., D.C. (July 2, 2012) [hereinafter Interview with CFTC].

[118] 17 C.F.R. §1.20.

[119] *Id.*

[120] 17 C.F.R. §1.23.

[121] 17 C.F.R. §30.7; 17 C.F.R. §1.3(rr) (setting forth definition of "Foreign Futures and Options Secured Amount"). In addition, when a foreign futures or options customer opens an account, an FCM must give written warning of the risks inherent in trading on a foreign exchange. 17 C.F.R. §30.6; *see also* 17 C.F.R. §1.55 (providing that disclosure must state, in part, that "funds received from customers to margin foreign futures transactions may not be provided the same protections as funds received to margin futures transactions on domestic exchanges").

FCM, if it chooses, may set aside funds equal to the net liquidated value of all customer property (the "Net Liquidation Method").[122] The difference between these two methods is that the Alternative Method does not require customer ledger or cash balance amounts to be included in the secured account, whereas the net liquidation method does.[123] The Alternative Method thus permits an FCM to maintain a lower minimum secured account balance than would be required under the Net Liquidation Method.[124]

On a daily basis, an FCM must determine (1) the account balances of its segregated and secured accounts, (2) the amounts required to be deposited by rule, and (3) the amounts of any excess it has deposited therein.[125] MFGI used the Alternative Method to calculate the amount required to be set aside in secured accounts, one of only five companies out of 55 FCMs that carried foreign customer funds to do so.[126] MF Global referred to the amount of its own funds maintained in MFGI's segregated and secured accounts as "Firm Invested in Excess."[127] Additionally, MF Global calculated the difference between the amount MFGI would be required to hold in its secured accounts under the Net Liquidation and Alternative Methods, and referred to the difference internally as "Regulatory Excess."[128]

Beginning in 2005, the CME Group required MFGI to report regulatory balances in the company's segregated and secured accounts on a daily basis; MFGI filed these statements with

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[122] Foreign Futures and Foreign Options Rulemaking, *supra* note 117 at 28, 984.
[123] Rep. of the Trustee's Investigation and Recommendations, *In re MF Global Inc.*., No. 11-2790 (MG) SIPA, at 38 (Bankr. S.D. N.Y. June 4, 2012) [hereinafter MFGI Trustee Report].
[124] MFGI Trustee Report, *supra* note 123, at 38, fn. 23. ("For example, if a customer deposits $100,000 in cash into her "30.7" Foreign Secured account on Day 1, in order to start trading on UK exchanges, but has no open positions, there is no maintenance margin requirement, and therefore, under the Alternate Method, there would be a $0 requirement for MFGI to set aside her deposited funds. Conversely, under the Net Liquidating Method, there would be a $100,000 requirement.")
[125] Rule 1.32 (requiring computation of balances by noon on the next business day).
[126] Following MF Global's collapse, one firm changed to the net liquidation method in Nov. 2011, and the remaining three changed in Jan. and Feb. 2012, after discussions with CFTC staff. Interview with CFTC, *supra* note 117. Further, FCMs were prohibited from using the alternative method as of Sept. 1, 2012, under rules proposed by the National Futures Association [hereinafter NFA] and approved by the CFTC.
[127] MFGI Trustee Report, *supra* note 123, at 11.
[128] *Id.*

the CFTC, the CME Group, and the NFA.[129] Because MFGI used the Alternative Method to determine the minimum required balances in its secured accounts, MFGI did not report the amount of Regulatory Excess on its daily secured statements.[130]

Corzine Creates Strategic Plan for MF Global

When Corzine became CEO of MF Global, he initiated a comprehensive review to assess the company's challenges and opportunities.[131] Corzine quickly learned that MF Global had two options for returning to profitability. One option would be to cut costs and wait for the global economy to improve. Corzine rejected this option, telling colleagues: "By doing nothing, you're making one of the biggest bets, ever. You're betting on interest rates."[132] The second option would be to seek new sources of revenue by branching out into new business lines.[133] Corzine pursued this option.

Over the course of 2010, Corzine, along with his senior management, crafted a strategic plan to transform MF Global into a full-service global investment bank within three to five years.[134] This plan, which was described by financial journalists as creating a "mini-Goldman," contained several elements.[135] First, MF Global would reorganize its business lines to expand into new services.[136] Second, in tandem with its reorganization, the company would also recreate its employee base and compensation structure to better support its planned new

[129] Dec. 15, 2011 Hearing, *supra* note 50, at 82 (Testimony of Terrence A. Duffy, Executive Chairman, CME Group Inc.); MFGI Trustee report, *supra* note 123, at 41.
[130] MFGI Trustee Report, *supra* note 123, at 39, 108; Interview by O&I Subcomm. staff with CME Group personnel, in Wash., D.C. (June 18, 2012) [hereinafter Interview with CME Group].
[131] Elkind Burke article, *supra* note 88; Form 10-K for MF Global Holdings Ltd. (fiscal year ended Mar. 31, 2011) [hereinafter FY11 10-K]
[132] Elkind Burke article, *supra* note 88.
[133] *Id.*
[134] FY11 10-K, *supra* note at 131.
[135] *See, e.g.*, Andrew Ross Sorkin, *It's Lonely Without the Goldman Net*, N.Y. TIMES, Oct. 31, 2011 (http://dealbook.nytimes.com/2011/10/31/its-lonely-without-the-goldman-net/) (last visited July 20, 2012).
[136] FY11 10-K, *supra* note 131, at 6-7.

activities.[137] Third, MF Global would finally secure MFGI's designation as a New York Fed primary dealer.[138] Fourth, the company would begin trading with its own funds as a means of generating profits to satisfy investors and avert further ratings downgrades while completing its transformation into an investment bank.[139]

Corzine Begins Implementing His Strategic Plan

Corzine lost no time in implementing his ambitious new strategic plan. He immediately began reorganizing MF Global's business lines by expanding its role in client facilitation, market-making, and principal activities; centralizing its retail services under a global brand; and consolidating its clearing and financing activities under one business group.[140] Additionally, he laid the groundwork for providing asset management, underwriting, structured finance, and advisory opinion services with a specialized focus on commodities and natural resources markets.[141]

To support these changes, Corzine also began to overhaul MF Global's employee base. The company laid off 10-15 percent of its 3,200 employees and began hiring new employees to undertake the company's planned services.[142] For these new hires, the company restructured compensation agreements by eliminating lockup provisions and tying bonuses to business unit profitability rather than broker performance alone.[143] Corzine also made significant changes to

[137] MF Global Ltd. F4Q10 (Qtr End 03/31/10) Earnings Call Transcript (May 20, 2010) [hereinafter FY10 Q4 MF Global Earnings Call].
[138] Corzine describe this as "one of his top priorities." See Terrence Dopp and Matthew Leising, *Corzine Returns to Wall Street as CEO of MF Global*, BLOOMBERG, Mar. 23, 2010 [hereinafter Dopp Leising article] (http://www.bloomberg.com/apps/news?pid=newsarchive&sid=akA2OHOzoQ2M&pos=4) (last visited Oct. 16, 2012).
[139] FY11 10-K, *supra* note 131, at 16.
[140] *Id.*, at 6-7.
[141] *Id.*
[142] FY10 Q4 MF Global Earnings Call, *supra* note 137. MF Global turned over nearly 46% of its workforce during Corzine's tenure, releasing 1,400 of its 3,200 workers and hiring 1,100 new employees. See Elkind Burke article, *supra* note 88.
[143] FY10 Q4 MF Global Earnings Call, *supra* note 137.

MF Global's senior management. On September 13, 2010, he hired Bradley Abelow as the company's Chief Operating Officer (COO).[144] Abelow had previously worked with Corzine at Goldman Sachs and later served as Corzine's Chief of Staff while he was governor of New Jersey.[145] Corzine also promoted Henri J. Steenkamp, the company's Chief Accounting Officer, to Chief Financial Officer (CFO), displacing the company's former-CFO, J. Randy MacDonald.[146]

Corzine also redoubled efforts to secure MFGI's primary dealer designation from the New York Fed, telling reporters that the designation was a "major part of his strategy to increase [company] revenue."[147] In April 2010, Corzine requested an opportunity to visit to the New York Fed's offices to discuss MFGI's candidacy.[148] New York Fed staff members had followed Corzine's appointment as MF Global's Chairman and CEO with interest, noting that his hiring was an indication that the company had "turned the corner on many fronts."[149] Even though officials at the New York Fed had found MF Global's Dan-era efforts to secure primary dealer designation "very aggressive (borderline obnoxious)" and had recently postponed approval of MFGI's application in response to the CFTC's regulatory action, the New York Fed agreed to Corzine's meeting request.[150]

Corzine visited with the New York Fed on June 1, 2010.[151] Following that visit, the New York Fed acted quickly on MFGI's application. Staff members discussed the company's candidacy with the CFTC on June 3, met internally for formal review sessions on August 5 and

[144] MF Global Holdings Ltd. Schedule 14A Proxy Statement (July 7, 2011), at 32.
[145] FY11 10-K, *supra* note 131, at 13.
[146] *Id.* at 13-14.
[147] Dopp Leising article, *supra* note 138.
[148] E-mail from Dzina, NYFRB, to Wolgemuth, NYFRB (Apr. 16, 2010, 03:01 p.m.).
[149] *Id.*; E-mail from Joshua Frost, NYFRB, to Dzina, NYFRB (Mar. 23, 2010, 05:46 p.m.); E-mail from David G. Sewell, NYFRB, to Dzina, NYFRB (Mar. 24, 2010, 09:00 a.m.).
[150] E-mail from Dzina, NYFRB, to Wolgemuth, NYFRB (Apr. 16, 2010, 03:01 p.m.); E-mail from Dzina, NYFRB, to Michael Schetzel, NYFRB (Apr. 22, 2010, 08:24 p.m.).
[151] NYFRB Chron, *supra* note 65, at 23.

September 23, and visited the company's headquarters on November 4.[152] Following the visit, New York Fed staff members indicated that they "[d]o not see any showstoppers and expect we will escalate for more formal approval sometime in Dec [sic] with operationalization [sic] early in new year."[153] The New York Fed proceeded to approve MFGI's application soon thereafter, securing final approvals in January 2011 — just after the company's one-year waiting period had expired — and publicly announcing the company's designation as a primary dealer on February 2, 2011.[154]

While MF Global pursued the primary dealer designation for MFGI, the company also began using its own funds in an effort to generate additional revenues. In some cases, MF Global used its money to facilitate client transactions by taking the other side of a trade entered into by a client.[155] The company also used its funds to "make markets" in particular securities.[156] Although these principal transactions helped MF Global post a modest profit of $8.8 million for its fiscal quarter ending June 30, 2010, they did not produce the levels of revenue necessary to sustain long-term profitability and fund the company's transformation into an investment bank.[157] Increasingly, Corzine looked to proprietary trading — using MF Global's own funds to take positions from which the company hoped to profit, if the market moved as it expected — as a way to further boost revenues.

To achieve the kinds of gains that Corzine sought, new employees with trading experience would be needed. To that end, in June 2010, Corzine formed a new division known as the Principal Strategies Group and hired new employees tasked with identifying trading

[152] *Id.* at 23-25.
[153] E-mail from Dzina, NYFRB, to Brian P. Sack, Fed. Reserve System (Nov. 12, 2010, 09:12 p.m.).
[154] Press Release, NYFRB, Primary Dealers List (Feb. 2, 2011) http://newyorkfed.org/newsevents/news/markets/2011/an110202p.html (last visited Oct. 23, 2012).
[155] FY11 10-K, *supra* note 131, at 16.
[156] *Id.* at 6-7.
[157] Form 10-Q for MF Global Holdings Ltd. (quarterly period ended June 30, 2010) at 41 (noting $8.8 million profit).

strategies for the company.[158] Corzine also maintained a portfolio within the Principal Strategies Group in order to personally execute proprietary trades.[159] MF Global's policies provided that an officer could make trades only if a more senior officer reviewed and approved the trades.[160] Because Corzine was the highest ranking officer at MF Global, he technically could not trade under this policy; however he reached a compromise whereby a subcommittee of the board of directors reviewed his trades, as well as any he directed others to place.[161]

The Principal Strategies Group soon identified what it thought was a promising trading opportunity. During the European debt crisis, sovereign bonds issued by several countries were trading at heavily discounted prices out of fear that these financially-troubled countries would default on their obligations.[162] On May 9, 2010, twenty-seven European nations created the European Financial Stability Facility (EFSF), a bailout fund meant to preserve financial stability in Europe by providing financial assistance to Eurozone countries experiencing acute economic difficulty.[163] Corzine and the Principal Strategies Group believed that this fund, which would not expire for several years, would protect the holders of short-maturity sovereign bonds against the risk of default.[164] They also believed that the bond markets had not fully incorporated this decreased risk into the price of the bonds, which created an opportunity to exploit the price

[158] FY11 10-K, *supra* note 131, at 7.
[159] *See, e.g.*, MF Global Capital Markets Weekly Management Meeting (week ending Oct. 19. 2011), page 12; E-mail from Spencer Salovaara, MF Global, to Jon Corzine, CEO, MF Global (Oct. 25, 2011, 09:46 p.m.); Elkind Burke article, *supra* note 88 (noting that Corzine "wasn't just trading RTMs…He was also trading oil futures and T-bills and foreign currencies" and that "Corzine tracked his positions…on his Bloomberg terminal, on his Blackberry, on his iPad")
[160] MFGI Trustee report, *supra* note 123, at 68, Footnote 61.
[161] *Id.*
[162] David Cottle, *Euro Sovereign Woes Bubble Back Up*, WALL ST. J., July 19, 2010 (http://blogs.wsj.com/source/2010/07/19/euro-sovereign-woes-bubble-back-up/) (last visited Oct. 23, 2012); Dec. 15, 2011 Hearing, *supra* note 50, at 132 (testimony of Jon Corzine, CEO, MF Global) (noting that spread in European sovereign debt securities appeared to be favorable).
[163] Press Release, Council of The European Union, European Stabilisation Mechanism to Preserve Fin. Stability (May 9, 2010).
[164] Dec. 15, 2011 Hearing, *supra* note 50, at 133 (testimony of Jon Corzine, CEO, MF Global).

dislocation and realize an unusually high return by acquiring the underpriced bonds and holding them to maturity.[165]

Despite Corzine's confidence in the profitability of an investment in the bonds, the investment — were MF Global to buy the bonds outright — would expose MF Global to volatility in its financial statements until the bonds reached maturity. Most of the bonds matured in either 2011 or 2012, which meant that MF Global would have to hold the bonds for a year or more before it realized profits on its investment.[166] Under the Generally Accepted Accounting Principles (GAAP) promulgated by the Financial Accounting Standards Board (FASB), the value of the bonds would have to be marked to market as assets daily and changes in value would have to be accounted for in the company's profits and losses.[167] If the bonds lost value before maturity, for instance, MF Global would have to report a loss until the company could redeem the bonds for par value at maturity.[168]

Because of this risk to the company's income statement and the time it would take to realize gains, a direct investment in the bonds themselves would not achieve Corzine's objectives. However, the company discovered that it could book quick profits by purchasing the bonds and then using them as collateral in a transaction known as a repurchase-to-maturity (RTM) agreement.[169]

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[165] *Id.* at 131-132.
[166] MF Global, Board of Directors European Sovereign Portfolio (Aug. 11, 2011) [hereinafter MF Global Euro Sovereign Portfolio].
[167] *See* MFGI Trustee Report, *supra* note 123, at 66 (noting that MFGI classified European bonds as "securities owned subject to MtM" before entering into intercompany repos with MFGUK). FASB is "the designated organization in the private sector for establishing standards of financial accounting that govern the preparation of financial reports by nongovernmental entities." *See* "Facts about FASB," available at http://www.fasb.org/jsp/FASB/Page/SectionPage&cid=1176154526495. While the SEC has authority to establish accounting standards for publicly held companies pursuant to the Securities and Exchange Act of 1934, *see* Exchange Act, Section 13b, the SEC generally has deferred to the private sector with respect to the formulation of accounting standards. *See* "Facts about FASB."
[168] *See* MFGI Trustee Report, *supra* note 123, at 66.
[169] Dec. 15, 2011 Hearing, *supra* note 50, at 132 (testimony of Jon Corzine, CEO, MF Global).

Traditional repurchase agreements are frequently used by companies to secure short-term financing.[170] A company, for instance, might sign an agreement with a counterparty in which the company agrees to sell securities or other assets to the counterparty and to repurchase the same or similar assets from the counterparty at a future date for an agreed-upon price.[171] Usually, the amount of cash the counterparty gives to the company is less than the fair market value of the securities or other assets.[172] This difference is known as the initial margin or "haircut" and protects the buyer against a decrease in the value of the assets prior to their resale to the company, illiquidity of the assets, and counterparty credit risk.[173] The initial margin level varies depending upon the credit rating of the security sold.[174] The counterparty to a repurchase agreement also usually has the right to demand additional margin (in other words, make a "margin call") during the term of the agreement to maintain the value of the collateral in cases where the value of the underlying assets falls during the term of the agreement.[175] The counterparty can also require a company to post additional margin if it questions the company's creditworthiness.[176] These additional types of margin are known as "variation margin," and can expose a company that is a party to a repurchase agreement to liquidity risk if margin calls

[170] The Repurchase Agreement Refined: GCF Repo, Current Issues in Economics and Finance, New York Fed, at 1 (June 2003), available at http://www.newyorkfed.org/research/current_issues/ci9-6.pdf (last visited Nov. 14, 2012).
[171] For example, a securities dealer may borrow $100 from its client for a week in exchange for a security worth $100. A week later, the securities dealer will return $105 to the client, and the client returns the security to the dealer. *See Regulating Wall Street: The Dodd-Frank Act and the New Architecture of Global Finance* at 321 (Viral V. Acharya et al., eds. 2011). Repos are functionally similar to a secured loan. Thus, the five dollars paid by the securities dealer in the foregoing example is interest on the $100 loan principal. *Id*.
[172] *Id.* at 321.
[173] *See* Richard Comotto, Haircuts and Initial Margins in the Repo Market, European Repo Council, at 5-6 (Feb. 8, 2012), available at: http://www.icmagroup.org/assets/documents/Maket-Practice/Regulatory-Policy/Repo-Markets/Haircuts%20and%20initial%20margins%20in%20the%20repo%20market_8%20Feb%202012.pdf; *see also* CFTC Glossary, "Haircut," available at: http://www.cftc.gov/consumerprotection/educationcenter/cftcglossary/glossary_h (last visited Oct. 24, 2012).
[174] *Id.*
[175] Dec. 15, 2011 Hearing, *supra* note 50, at 132 (Statement of Jon Corzine, CEO, MF Global).
[176] *Id.*; *see also* MFGI Trustee Report *supra* note 123, at 89 (noting that if MF Global were downgraded below investment grade, "that event would trigger a margin call as high as 200% under LCHC rules and higher margin at other exchanges like Euroex").

require the company to post cash and sell securities to cover its obligations.[177] Under FASB's accounting standards, traditional repurchase agreements are accounted for as a secured borrowing in which the company recognizes cash as proceeds from the transaction, together with a liability for the repurchase price specified in the agreement.[178] The collateral remains on the company's balance sheet as an asset, and any impairment to the collateral would be recognized in earnings over time.[179]

An RTM differs from a traditional repurchase agreement in one important respect. In a traditional repurchase agreement, the securities held by a counterparty are returned to the borrowing company before the securities collateralizing the borrowing reach maturity.[180] By contrast, in an RTM transaction, the counterparty keeps the pledged securities as collateral until they mature, whereupon the counterparty may either return the securities to the borrowing company or redeem them from their issuer at par value.[181] Under FASB's accounting standards, because a counterparty may redeem securities from an issuer at maturity rather than return them to the borrowing company, the borrowing company surrenders effective control of the securities when it transfers them as collateral to the counterparty.[182] Accordingly, FASB accounting standards require that the borrowing company account for the transaction as a "sale" of the securities coupled with a forward repurchase commitment, rather than a secured borrowing.[183] The forward repurchase commitment must be accounted for as a derivative at fair market value

[177] Memorandum from Andrea Kennedy, Mike Bolan, Pallavi Rayan, MF Global to MF Global files (Mar. 31, 2011) [hereinafter MF Global RTM Memo].
[178] FASB, Transfers and Servicing, Topic 860 [hereinafter FASB Topic 860].
[179] *Hearing on The Collapse of MF Global: Part 3 Before the Subcomm. on O&I of the House Comm. on Fin. Services*, 112th Cong. 10 (2012) [hereinafter Mar. 28, 2012 Hearing] (testimony of Susan M. Cosper, Technical Dir., Chairman, Emerging Issues Task Force, FASB).
[180] *Id.*
[181] *Id.*
[182] FASB Topic 860, *supra* note 178, 860-10-40-5.
[183] *Id.*

on the company's balance sheet, with changes in value recognized concurrently in income.[184] While the borrowing company retains the default and liquidity risks associated with the securities serving as collateral, the securities are "derecognized" from the company's balance sheet because they are deemed to be sold by the borrowing company at the time it enters into the RTM transaction with the counterparty.[185]

MF Global learned that by entering into RTM transactions collateralized with European sovereign bonds (European RTM trades) it could realize an immediate profit on the difference between the interest the issuer of the bonds paid to MF Global and the rate the company paid to its counterparty to repurchase the bonds, and that it could derecognize the bonds from its balance sheet.[186] Armed with an investment strategy that he believed could book instant profits for MF Global without affecting its balance sheet and a belief that the EFSF mitigated against sovereign default risk, Corzine ordered the company to place its first European RTM trades.[187]

In the late summer of 2010, MFGUK, on MFGI's behalf, bought approximately $1 billion of bonds issued by Ireland, Italy, Portugal, and Spain.[188] MFGUK then sold the bonds to MFGI, which used them as collateral in intercompany RTM transactions with MFGUK. MFGUK then entered into further RTM transactions, which cleared through LCH.Clearnet (LCHC).[189] This arrangement was necessary because only MFGUK maintained a trading relationship with LCHC.[190] At the time, all of the bonds serving as collateral were considered

[184] FASB, Derivatives and Hedging, Topic 815 [hereinafter FASB Topic 815]; *see also* FASB, Fair Value Measurement, Topic 820 [hereinafter FASB Topic 820].
[185] FASB Topic 860, *supra* note 178.
[186] Dec. 15, 2011 Hearing, *supra* note 50, at 131 (Statement of Jon Corzine, CEO, MF Global).
[187] *Id.* at 133.
[188] Elkind Burke article, *supra* note 88.
[189] MFGI Trustee Report, *supra* note 123, at 124. The London Clearing House Ltd. merged with Banque Centrale de Compensation SA (then trading as Clearnet) in Dec. 2003 to form the LCH.Clearnet Group Ltd. See LCH.Clearnet Annual Report 2003, at 4, available at: http://www.lchclearnet.com/Images/RA%202003_tcm6-44282.pdf (last visited Oct. 23, 2012).
[190] MF Global RTM Memo, *supra* note 177.

investment grade, so LCHC required margin as low as 3% to support the trades.[191] Once MF Global entered into the European RTM trades, it booked a profit on the difference between the interest paid by the issuer of the bonds and the repurchase rate specified in the RTM transactions that it cleared through LCHC, and then derecognized the bonds from its balance sheet.

Corzine Expands European Sovereign Debt Portfolio

Under MF Global's internal policies and procedures, the company's trades were normally subject to review by internal risk managers and multiple layers of management.[192] While MF Global's European RTM trades continued to be reviewed by the risk management department, the board of directors made decisions about the firm's risk appetite and whether the positions exceeded that risk appetite beginning after September 2010.[193] Staff from the Principal Strategies Group regularly updated Corzine on movements in the prices of trades supporting the company's European RTM trades.[194] Corzine, who had taken personal responsibility for the trades, communicated directly with MF Global personnel about the trades, and sometimes instructed them when to enter and exit various positions.[195] In setting the company's risk

[191] Dec. 15, 2011 Hearing, *supra* note 50, at 133 (Statement of Jon Corzine, CEO, MF Global); MFGI Trustee Report, *supra* note 123, at 67; First Rep. of Louis J. Freeh, Chapter 11 Trustee of MF Global Holdings Ltd., et al., for the Period Oct. 31, 2011 through June 4, 2012, at 35, *In re MF Global Holdings Ltd*., Case No. 11-15059 (MG) (June 4, 2012) [hereinafter Freeh Report].
[192] MF Global Holdings Ltd., Board of Directors Delegations of Authority for Risk (Sept. 27, 2007), at 2, 9-10.
[193] Dec. 15, 2011 Hearing, *supra* note 50, at 133-134 (Statement of Jon Corzine, CEO, MF Global).
[194] *Id.*, at 37, 41-42, 132, 134. Corzine characterized the trades as "my personal responsibility and a prime focus of my attention." Matthew Leising, *MF Global Drops by Most Since 2008 on Biggest Quarterly Loss*, BLOOMBERG BUSINESSWEEK, Oct. 25, 2011 (http://www.businessweek.com/news/2011-10-25/mf-global-drops-by-most-since-2008-on-biggest-quarterly-loss.html#p2) (last visited July 21, 2012); E-mails from Lauren Cantor, MF Global, to Jon Corzine, CEO, MF Global (Oct. 24, 2011). In Jan. 2011, Corzine began acting, on an "interim" basis, as the head of the company's institutional capital markets division, in which the Principal Strategies Group was housed. MF Global Holdings Ltd. Board of Directors Meeting Minutes, at 3 (Jan. 28, 2011). Shortly after the Jan. board meeting, Munir Javeri was hired as MF Global's Global Head of Trading; Elkind Burke article, *supra* note 88. Javeri left MF Global in June 2011, however, reportedly "after expressing discomfort with the RTMs." *Id.*
[195] *See, e.g.*, E-mail from Jon Corzine, CEO, MF Global, to Lauren Cantor, MF Global (Mar. 9, 2011, 10:30 a.m.) (instructing Ms. Cantor to "work" Italian RTM trades); MFGI Trustee Report, *supra* note 124, at 68.

appetite regarding the European RTM trading strategy, the board normally relied upon the input of Corzine and the firm's chief risk officer, Michael Roseman.[196]

By September 2010, MF Global had increased its European RTM portfolio to between $1.5 billion and $2.0 billion.[197] As Corzine pushed for even more trades, Roseman began to question them based on liquidity risk concerns relative to the company's approved risk appetite.[198] Roseman met with Corzine to express his concerns, and the two agreed to consult MF Global's board of directors at its mid-September board meeting.[199] At the meeting, Corzine pushed for an overall exposure of $4 billion, which the board approved.[200] The same month, Corzine retained a search firm to find a new chief risk officer for the company.[201]

As MF Global's portfolio approached its $4 billion limit in late October of 2010, Roseman became further concerned about the liquidity risks and potential capital at risk of the European RTM trades, and again met with Corzine to express his views.[202] MF Global's board of directors met shortly thereafter, on November 8, 2010.[203] At the board meeting, Corzine sought, and the board approved, an increase in the company's European RTM portfolio limit to $4.75 billion.[204] Also in November, Corzine informed Roseman that he would no longer report directly to the board, but would report instead to Abelow, the company's COO and Corzine's long-time colleague.[205]

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[196] Michael Roseman timeline provided to O&I Subcomm. (July 17, 2012) [hereinafter Roseman timeline].
[197] *Id.*
[198] *Id.*
[199] *Id.*
[200] *Id.*
[201] Elkind Burke article, *supra* note 88.
[202] Roseman timeline, *supra* note 196.
[203] MF Global Holdings, Ltd. Board of Directors Meeting Minutes (Nov. 8, 2010).
[204] *Id.* at 2.
[205] Letter from Samuel F. Abernethy, attorney for Michael K. Roseman, to Randy Neugebauer, Chairman, Subcomm. on O&I, at 1 (Feb. 24, 2012).

On November 5, 2010, MF Global announced a $38.7 million loss for the fiscal quarter ending on September 30.[206] That same month, LCHC imposed a 15% haircut on certain Irish bonds owned by MFGI, forcing the company to meet a margin call.[207] Later that month, S&P downgraded MF Global's rating to BBB-, just one notch above junk status.[208] S&P attributed MF Global's continued weak performance to lower volumes, low interest rates, and changes in the company's operating strategy.[209] S&P also noted that it expected Corzine's strategic plan to increase the company's risk profile and delay its return to profitability over the near- to medium-term.[210]

In January 2011, Corzine dismissed Roseman and replaced him with a new chief risk officer, Michael Stockman.[211] Like Roseman, Stockman reported to Abelow, the COO.[212] In preparing for his new position, Stockman met with Roseman, at which time the two discussed the European RTM trades as an item of interest to MF Global.[213] Stockman also reviewed minutes of board meetings from November and December at which risks associated with the European RTM trades were discussed.[214]

On February 3, 2011, MF Global reported another loss of $4.7 million for the fiscal quarter ending December 31, 2010.[215] The same day, Moody's noted MF Global's "weak" credit metrics and stated that it would evaluate "[o]ver the next four to six quarters…whether MF

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[206] Form 10-Q for MF Global Ltd. (quarterly period ended Sept. 30, 2010), at 1 [hereinafter FY11 Q2 10-Q]
[207] MF Global RTM Memo, *supra* note 177, at 4.
[208] S&P, *Research Update: MF Global Holdings' Rating is Lowered to 'BBB-'; Outlook Stable*, Nov. 24, 2010.
[209] *Id.*
[210] *Id.*
[211] Letter to Michael Roseman from Thomas F. Connolly, Global Head of Human Resources, MF Global (Feb. 24, 201), at 1; Michael Stockman timeline provided to O&I Subcomm. (June 21, 2012), at 4,6 [hereinafter Stockman timeline]. Stockman had been contacted about applying for the position on Sept. 16, 2010.
[212] Stockman Timeline, *supra* note 211, at 5.
[213] *Hearing on The Collapse of MF Global: Part 2 Before the Subcomm. on O&I of the House Comm. on Fin. Services*, 112th Cong. 37 (testimony of Michael Stockman, Global CRO, MF Global Holdings Ltd.) [hereinafter Feb. 2, 2012 Hearing].
[214] *Id.*
[215] Form 10-Q for MF Global Ltd. (quarterly period ended Dec. 31, 2010) [hereinafter FY11 Q3 10-Q].

Global can 1) reengineer the franchise to generate annual pre-tax earnings in the $200M-$300M range, 2) keep balance sheet leverage in the 20x range, and 3) maintain the necessary liquidity and risk management discipline as it executes its…strategy."[216] At the end of February, Stockman met with Martin Glynn, a member of MF Global's board of directors, in part to discuss Glynn's background and visions for MF Global.[217] Before the meeting, Glynn informed Stockman that one of his concerns was the level of risk associated with MF Global's European RTM portfolio.[218] Glynn told Stockman that he would "be under tremendous pressure…to approve higher risk limits in non core areas to support earnings weaknesses elsewhere."[219]

Corzine continued to push forward with his European RTM trading strategy. In early March, MF Global's board of directors approved — with the newly-hired Stockman's support — a further increase in the company's portfolio limit to $5.8 billion until March 31, 2011, for the bonds of Ireland, Italy, Portugal, and Spain, at which time the limit for those countries would decrease to $5 billion.[220] In late March, the board of directors extended the temporary limit of $5.8 billion to September 30, 2011, including a separate $1 billion limit for Belgium.[221]

On May 20, MF Global reported its fiscal 2011 year-end results.[222] The company lost $81.2 million, $46.5 million of which came in the fiscal quarter ended March 31, 2011.[223] At the

[216] Press Release, Moody's, Moody's affirms MF Global's Baa2 rating, maintains negative outlook (Feb. 3, 2011).
[217] E-mail from Michael Stockman, CRO, MF Global, to Martin Glynn (Feb. 24, 2011, 07:44 p.m.).
[218] *See* E-mail from Martin Glynn, to Michael Stockman, CRO, MF Global (Feb. 25, 2011, 03:00 p.m.).
[219] *Id.*
[220] Memorandum from Michael Stockman, CRO, MF Global, to MF Global Board of Directors (Mar. 2, 2011). In the memo, Stockman wrote that the "European sovereign trade is a unique opportunity in the capital markets to earn reasonable to high reward to risk returns relative to other available strategies." Despite the fact that the "transactions [had] default or restructuring risk," those risks were "not the focus" of Stockman's "current market risk analysis" because, "[b]ased on current spreads, the market is pricing in a very small probability of this scenario." In the memo, however, Stockman estimated that the RTM positions could subject the company to margin calls and haircuts of between $297 million and $761 million. *Id*.
[221] MF Global Holdings Ltd., Executive Committee of the Board of Directors, Meeting Minutes, at 2 (Mar. 23, 2011); Stockman timeline, *supra* note 211, at 1.
[222] FY11 10-K, *supra* note 131.
[223] *Id.*

time, the value of MF Global's net European RTM portfolio was approximately $6 billion.[224] At a board meeting two weeks later, in early June, Corzine requested another portfolio limit increase to $8.4 billion.[225] When the board asked to meet without management present, Corzine said, outside the board's presence, that if the board didn't think he was the "right guy," maybe they "should find someone else [to run the company]."[226] After a discussion in which board members expressed concern about the company's European sovereign debt exposure, the board approved limits of $6.6 billion for Belgium, Italy, and Spain, and of $1.9 billion for Ireland and Portugal, for a total limit equaling $8.5 billion.[227] Stockman offered conditional support for the increase, provided that Henri Steenkamp, MF Global's CFO, ensured that the firm had adequate liquidity to meet stress scenarios.[228] MF Global's net exposure on its European RTM portfolio reached $6.4 billion at the end of June.[229]

By July 2011, as market conditions in Europe deteriorated, Stockman became concerned about an increasing risk of margin calls and bond default, and met twice with Corzine, Steenkamp, the company's sovereign debt and finance desk traders, and members of the company's Risk Department to discuss the European RTM portfolio.[230] During the meetings, Stockman provided detailed information about MF Global's daily sovereign risk report and liquidity stress scenarios and recommended that the company enter into "hedging" RTMs as a means of reducing the firm's net exposure.[231] Stockman advised that "Europe could get worse before it gets better," and recommended that the company develop a contingency plan to reduce

[224] Stockman timeline, *supra* note 211, at 1.
[225] *Id.*
[226] *Id.*
[227] *Id.*
[228] *Id.*
[229] Form 10-Q for MF Global Ltd. (quarterly period ended June 30, 2011), at 90.
[230] Stockman timeline, *supra* note 211, at 1-2.
[231] *Id.* at 2.

MF Global's European sovereign debt exposure.[232] On July 30, 2011, Stockman memorialized his concerns and recommendations in an e-mail to Corzine, explaining that he did not support further increasing MF Global's European sovereign debt position, and recommended entering into more hedges to reduce the company's net exposure.[233]

By August 2011, the company's net European RTM position had reached approximately $7.4 billion.[234] This amount represented almost 14% of MF Global's assets and four-and-a-half times its total equity, and when measured as a percentage of equity or assets, the amount was significantly greater than its far larger competitors.[235] At the board's August 11 meeting, Corzine stated — this time in the presence of directors — that the board should consider replacing him as CEO if it no longer had confidence in his ability to run the company.[236] Stockman spoke about the continued risks to MF Global from its European sovereign debt positions and revealed that the company could need between $246 million and $930 million in additional funding to support margin calls and haircuts, if the value of the bonds further decreased.[237] Rather than using hedges as the primary means to reduce the company's exposure, which the board and Corzine deemed too costly, the board decided to cap MF Global's portfolio and allow the European RTM trades to "roll off" as the underlying bonds reached maturity, which would allow the company's net position to decrease over time.[238] The board also ordered management to prepare a "break the glass" plan, which outlined how the MF Global would

[232] *Id.*
[233] E-mail from Michael Stockman, CRO, MF Global, to Jon Corzine, CEO, MF Global (July 30, 2011, 02:33 p.m.); Stockman timeline, *supra* note 211, at 3.
[234] MF Global Euro Sovereign Portfolio, *supra* note 166, at 6.
[235] Memorandum from MF Global Investor Relations to MF Global Board of Directors (Oct. 2011).
[236] Stockman timeline, *supra* note 211, at 4. Stockman informed O&I Subcomm. staff that his recollection of Corzine's statement to the board of directors is based on a conversation that Stockman had with another MF Global employee after the Aug. 2011 board meeting.
[237] Stockman timeline, *supra* note 211, at 3; MF Global Euro Sovereign Portfolio, *supra* note 166, at 2.
[238] Telephone Interview by O&I Subcomm. staff with Michael Stockman, in Wash., D.C. (June 13, 2012); Feb. 2, 2012 Hearing, *supra* note 213, at 3 (statement of Michael Stockman, Global CRO, MF Global Holdings Ltd.).

respond to a credit downgrade and the liquidity demands arising from consequent margin calls.[239] The plan, which was distributed to the board in mid-October, noted that the European RTM trades were "the biggest draw on cash today" and that the company "need[ed] a clear strategy" for how to manage the trades in the event of a downgrade.[240] The plan estimated that MF Global had sufficient liquidity to "manage through one month under a severe stress event."[241]

MF Global's Independent Auditor Advises the Company to Enhance Disclosures about its European RTM Trades

When MF Global began entering into European RTM trades in September 2010, it accounted for the transactions as sales of the collateralized European sovereign bonds, which the company derecognized from its balance sheet, coupled with forward commitments to repurchase the bonds, which the company accounted for as derivatives. Because FASB's accounting standards require companies to mark-to-market the value of derivatives, MF Global sought to determine the fair value of the derivatives associated with the forward commitment.[242] The company used a valuation model that considered changes in value of the European bonds that collateralized the European RTM trades and changes in value of the forward repurchase commitments.[243] MF Global stated that in addition to these two factors, it further estimated the probability that the sovereign issuer would default on the bonds collateralizing the European RTM trades and then used the probability as a factor discounting the valuation of the

[239] Mar. 28, 2012 Hearing, *supra* note 179, at 92 (testimony of Henri Steenkamp, CFO, MF Global Holdings Ltd.); Feb. 2, 2012 Hearing, *supra* note 213, at 76 (testimony of Mr. Michael Stockman, Global CRO, MF Global Holdings Ltd.); MF Global, Stress Scenario Analysis—Downgrade Potential Impact on MF Global (Oct. 13, 2011).
[240] MF Global, Stress Scenario Analysis—Downgrade Potential Impact on MF Global (Oct. 13, 2011).
[241] *Id.*
[242] FASB Topic 820, *supra* note 184.
[243] Telephone Interview by O&I Subcomm. staff with PricewaterhouseCoopers [hereinafter PwC] personnel, in Wash., D.C. (Oct. 10, 2012) [hereinafter Telephone Interview with PwC].

derivatives.[244] The company determined that gains or losses attributable to the changing values of derivative were so small that they were immaterial for reporting purposes as of the end of September.[245]

On November 5, 2010, MF Global filed its unaudited quarterly 10-Q report with the SEC for the fiscal quarter ending on September 30, 2010.[246] The report did not specifically state that the company had entered into RTM transactions collateralized with European sovereign debt, but stated generally that "we also enter into certain resale and repurchase agreements that are accounted for as sales and purchases and accordingly de-recognize the related assets and liabilities from the unaudited consolidated balance sheet."[247]

Beginning in December 2010, PwC pressed MF Global to disclose more information about the European RTM trades in the company's regulatory disclosures.[248] In light of the requirement that companies value derivatives at fair value, PwC additionally advised MF Global that it should revise the methodology by which it valued the derivatives associated with the European RTM trades.[249] According to MF Global executives, PwC counseled that the company

[244] Telephone Interview by O&I Subcomm. staff with MF Global executive, in Wash., D.C. (Oct. 4, 2012) [hereinafter Telephone Interview with MF Global Exec.]. PwC, MF Global's independent auditor, described the model differently; in their view, the model did not incorporate a separate probability-of-default input, and it did not independently consider the value of the repurchase agreement. Telephone Interview with PwC, *supra* note 243.
[245] In addition, when MF Global revised its valuation methodology in Jan. 2011, the company reassessed the value of the derivative as of Sept. 30, 2010 and determined that, under the revised method, the value of the derivative was immaterial. Telephone Interview with MF Global Exec., *supra* note 244.
[246] FY11 Q2 10-Q, *supra* note 206.
[247] *Id.*
[248] PwC Two-Legged Repo to Maturity Audit Memorandum (Dec. 31, 2010), at 3 [hereinafter PwC Dec. 31, 2010 Audit Memo].
[249] Telephone Interview with PwC, *supra* note 243.

should not consider the probability of a default as a separate component in valuing the derivative, specifically, a change that could cause the company to recognize gains or losses.[250]

On December 23, PwC partners met with Corzine and other senior management at MF Global to discuss, among other things, the company's accounting of the European RTM trades, including its valuation of the derivatives.[251] In PwC's view, the meeting went poorly.[252] Corzine did not want to discuss accounting specifics and complained that he would not have entered into the European RTM trades if he had understood that marking the derivatives to market could result in volatility in the company's profits and losses.[253] PwC staff's impression of the meeting was that Corzine characterized the accounting and valuation requirements as a "PwC issue, and not [MF Global's]."[254] Additionally, PwC's staff described Corzine as feeling "ambushed," "bushwhacked," and extremely unhappy by PwC's advice.[255]

In January 2011, MF Global adopted a revised valuation methodology to better capture changes in the value of the derivative due to changes in the market value of the European bonds

[250] Telephone Interview with MF Global Exec., *supra* note 244. According to PwC staff, PwC counseled that MF Global adopt a methodology that incorporated additional market factors and that independently considered the bond and repurchase agreement values. Telephone Interview with PwC, *supra* note 243.
[251] *Id.*
[252] E-mail from George C. Gallagher, Partner, Banking and Capital Markets, PwC, to Peter M. Messana, PwC (Jan. 3, 2011, 06:34 a.m.).
[253] *Id.*
[254] *Id.*
[255] PwC Memorandum (Dec. 23, 2010). In an interview with O&I Subcomm. staff, one of MF Global's executives recounted his belief that PwC was aware of, and did not object to, MF Global's use of the "probability-of-default" valuation approach. The executive further recounted that PwC was present at a meeting of the audit committee of MF Global's board of directors during the fall of 2010, at which the audit committee discussed the probability-of-default approach. As a result, the executive indicated, MF Global's management did not anticipate that PwC would advise the company in Dec. 2010 that it should change the way it valued the derivative associated with the forward repurchase commitment. Telephone Interview with MF Global Exec., *supra* note 244. On the other hand, PwC stated in an interview with O&I Subcomm. staff that it never approved or otherwise opined on a valuation method that incorporated an explicit "probability-of-default" input. Telephone Interview with PwC, *supra* note 243. Further, PwC stated that it did not recall being present at an audit committee meeting at which the committee discussed such a valuation methodology. *Id*.

and repurchase agreement rates.[256] Pursuant to the revised valuation methodology, the company valued the derivative resulting from its European RTM trades at $60,000 for the quarter ended December 31, 2010, an amount that the company deemed immaterial for reporting purposes.[257] PwC tested the new methodology, which did not incorporate any discrete probability-of-default factor, and determined that it was appropriate given readily available information.[258] At the same time, MF Global told PwC that it was "in the process of enhancing their disclosures given the increased trading activity in the RTMs."[259]

On February 3, 2011, MF Global filed its 10-Q report for the quarter ended December 31, 2011.[260] In the report, MF Global disclosed that it "enters into securities financing transactions that mature on the same date as the underlying collateral" and that it "accounts for these transactions in accordance with the accounting standard for transfers and servicing and recognizes a gain or loss on the sale…of the collateral assets, and records a forward commitment [to repurchase the collateral]."[261] While the company did not state whether it accounted for the forward commitment as a derivative at fair value, it disclosed that it had "exposure to the risk of default of the issuer of the underlying collateral assets, such as U.S. government securities or European sovereign debt."[262] Finally, MF Global disclosed the total value of all of the securities it had sold under agreements to repurchase during the quarter, but did not specifically disclose the amount that had been collateralized by European bonds.[263]

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[256] PwC Test Forward Repurchase Commitment Audit Memorandum (Dec. 31, 2010), at 2.
[257] *Id.*
[258] *Id.*
[259] PwC FY11 Q3 MF Global Update Meeting Minutes (Jan. 25, 2011); *see also* PwC Dec. 31, 2010 Audit Memo, *supra* note 248, at 3 (noting "Management has added additional disclosures beginning in the 3rd quarter 10Q").
[260] FY11 Q3 10-Q, *supra* note 215.
[261] FY11 Q3 10-Q, *supra* note 215, at 14, 80.
[262] *Id.* at 14.
[263] *Id.*

MF Global discussed its European RTM trades in detail in the fiscal year 2011 10-K report it filed with the SEC on May 20, 2011.[264] In a section of the 10-K report entitled "Off-Balance Sheet Arrangements and Risk," MF Global explained that it entered into "[c]ertain resale and repurchase transactions involv[ing] the sale and repurchase of the underlying collateral[,] which generally mature on the same date as the underlying collateral," and that some of these transactions were collateralized by the obligations of European sovereign issuers.[265] The company further disclosed that it retained exposure not only to the risk of default of the issuer, but also to the risk of margin calls to the extent the value of the collateral decreased.[266] MF Global also noted that market risks associated with the European RTM trades included, but were not limited to, "interest rate, credit spread, rating downgrade and issuer default risks."[267] Finally, the company reported that it had invested in the bonds of Belgium, Ireland, Italy, Portugal, and Spain, that these bonds matured not later than December 2012, and that its net position in European RTM trades was $6.3 billion.[268]

Elsewhere, in the fiscal year 2011 10-K, MF Global stated that it accounted for forward repurchase commitments as derivatives that are marked-to-market, and that changes in the value of the derivatives "may cause volatility" in its financial results.[269] In separate statements filed by MFGI with the SEC, FINRA, and CBOE, the company disclosed that losses associated with

[264] FY11 10-K, *supra* note 131.
[265] *Id.* at 71. In 2003, pursuant to a mandate contained in the Sarbanes-Oxley Act of 2002, the SEC adopted rules requiring the disclosure of a company's off-balance sheet arrangements. *See* Sarbanes Oxley Act of 2002, Pub. L. No. 107-204 (July 30, 2002), §401. As a result, MF Global was required to explain its off-balance sheet arrangements in a specially captioned part of its regulatory filings. Disclosure in Management's Discussion and Analysis About Off-Balance Sheet Arrangements and Aggregate Contractual Obligations, 2003 WL 175446 (SEC Jan. 28, 2003).
[266] *Id.* at 49.
[267] *Id.* at 76.
[268] *Id.* at 77-78.
[269] *Id.* at 71.

these derivatives were immaterial as of March 31, 2011.[270] As a result, MF Global neither recorded the derivatives as assets or liabilities on its consolidated balance sheet, nor did it reflect any losses or gains attributable to the derivatives on its income statement.[271]

Mounting Liquidity Strain

By the summer of 2011, it had become clear to MF Global that Corzine's strategic plan had increased the company's liquidity demands.[272] In June, MF Global's internal auditors assessed the processes and controls in place to manage the company's liquidity.[273] The auditors found numerous and significant gaps between the company's liquidity policies and existing practices. Among other problems, the internal auditors found that "existing liquidity reporting is manual in nature," that MF Global had never established a "formal liquidity management framework," and that "existing performance of formal stress testing and scenario analysis is not adequate to fully assess liquidity and capital needs."[274]

After observing MF Global's continuous losses and business changes, SEC staff requested a meeting with MFGI executives on June 14, 2011.[275] At the meeting, MF Global staff, including Corzine, discussed the company's organizational and managerial changes, its progress implementing its strategic plan, and its liquidity, market, and credit risk management

[270] MFGI, Annual Audited Financial Statement, Note 4 (March 31, 2011).
[271] *See, e.g.*, PwC Partner notes, meeting with Jon Corzine (Apr. 27, 2011) (noting that RTM volatility was as yet "not material" but that Corzine "understood the fwd was at fair value and could *introduce* volatility into the P&L") (emphasis added).
[272] MF Global, Global Liquidity and Capital Management, Internal Audit Report, at 2 (June 2011).
[273] *Id.*
[274] *Id.*
[275] E-mail from Kari Jin, Broker Dealer Risk Office, SEC, to Bob Larson, CBOE, and Jeffrey Fortune, Fin. Industry Regulatory Authority [hereinafter FINRA] (June 7, 2011, 10:56 a.m.). The meeting was part of the SEC's 17-H program, which authorizes regulators to analyze "financial dependencies and unregulated business activities which could potentially affect the net capital, liquidity, financing or profitability of [MFGI]." SEC Risk Assessment Program. http://www.sec.gov/divisions/marketreg/bdriskoffice.htm (last visited July 19, 2012). MF Global's losses and changing business model had caused "concerns" at the SEC, prompting SEC staff members to request the June meeting. E-mail from Melanie Chan, SEC, to Jeffrey Fortune, FINRA (June 14, 2011, 12:29 p.m.). The SEC previously met with MF Global executives in Jan. 2010 and held a conference call on Apr. 6, 2011 pursuant to the 17-H program. See E-mail from Matt McGarvey, Branch Chief, 17-H Broker Dealer Operations, Div. of Trading and Markets, SEC, to Robert W. Cook, Dir., Div. of Trading and Markets, SEC (Dec. 9, 2011, 05:05 p.m.).

practices.[276] MFGI also provided a presentation that depicted its financial health relative to that of MF Global's.[277]

As liquidity demands increased, MF Global looked to additional sources of capital to support its operations. The company could draw from its $1.5 billion liquidity facility and could secure short-term financing through traditional repurchase agreements. Increasingly, however, the company began to turn to excess funds on deposit with its FCM accounts as a source of liquidity. In July, Henri Steenkamp discussed with Christine Serwinski, MF Global's North American CFO, whether the company's "Regulatory Excess" — the amount of futures customer funds deposited in secured accounts in excess of the regulatory requirement under the Alternative Method — could be loaned to the company to help meet its liquidity needs.[278] At the time, the amount of "Regulatory Excess" maintained by the company averaged about $1 billion.[279] After consulting with colleagues and the company's attorneys, Serwinski determined that the CFTC's rules did not prohibit MF Global from using the Regulatory Excess.[280] She advised Steenkamp, however, that she did not agree with using customer funds from the FCM to provide liquidity to the broker-dealer.[281] Serwinski advised Steenkamp that MF Global should consider only "Firm Invested In Excess" funds to satisfy its liquidity needs, which were the

[276] MF Global 17-H Meeting Agenda (June 14, 2011).
[277] MF Global SEC Presentation, *supra* note 97.
[278] *See* E-mail from Edith O'Brien, Ass't Treasurer, MF Global, to Christine Serwinski, North American CFO, MF Global (July 19, 2011, 2:37 p.m.) (asking about Serwinski's call with Steenkamp regarding use of excess funds). In an interview with O&I Subcomm. staff, Christine Serwinski stated that, to her belief, Jon Corzine initiated the request that Steenkamp discuss with Serwinski whether the Regulatory Excess could be used for this purpose. Telephone Interview by O&I Subcomm. staff, with Christine Serwinski, North American CFO, MF Global, in Wash., D.C. (July 23, 2012) [hereinafter Telephone Interview with Serwinski].
[279] MFGI Trustee Report, *supra* note 123, at 38.
[280] E-mail from Christine Serwinski, North American CFO, MF Global, to Henri Steenkamp, CFO, MF Global (July 27, 2011, 04:25 p.m.).
[281] E-mail from Christine Serwinski, North American CFO, MF Global, to Edith O'Brien, Ass't Treasurer, MF Global (July 19, 2011, 02:46 p.m.).

company's own funds deposited in the segregated and secured accounts.[282] From time to time, the company used this cushion for overnight and intraday transfers to help meet liquidity demands.[283] According to the trustee for MFGI's liquidation, however, the company also used a part of the Regulatory Excess at times for intraday funding during its last week of operation.[284]

By September, LCHC required MF Global to post more than $400 million in margin to cover its positions.[285] In early October, Steenkamp informed Corzine that the company needed to address its sustained liquidity stress.[286] Steenkamp cautioned that reliance on excess funds on deposit in the FCM should be temporary, but was becoming permanent.[287] He noted that MFGI's broker-dealer business was unable to fund itself, in part, because of the "permanent pool of liquidity" needed for MF Global's European RTM trades.[288] Steenkamp tasked two MF Global employees with presenting options that MF Global could immediately take to alleviate the company's liquidity pressure.[289]

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[282] In the event that the aggregate assets on deposit in customer segregated and secured accounts were less than MF Global's liabilities to customers under the Net Liquidation Method, Serwinski and her colleagues determined that MFGI would have to "lock up" funds equal to the difference in the *securities* customer reserve account that the company maintained pursuant to Rule 15c3-3. MFGI Trustee Report, *supra* note 123, at 77. MF Global's employees made this determination after consulting guidance issued by FINRA interpreting Rule 15c3-3. E-mail from Matthew Hughey, Controller, Fin. Regulatory Group, MF Global, to Christine Serwinski, North American CFO, MF Global (July 28, 2011, 12:47 p.m.). Under the rule, MF Global determined the amounts to set aside in the 15c3-3 account as of the close of business each Fri. and at the end of the month.

[283] *See, e.g.*, MFGI Trustee Report, *supra* note 123, at 77-78. Because MF Global was transferring funds within the same legal entity, the "loans" that MF Global referred to were not loans in any legal sense, but rather were merely transfers of funds.

[284] *Id.* at 103 (noting transfers exceeding firm invested in excess on Wed., Oct. 26, 2011).

[285] MFGI Trustee Report, *supra* note 123, at 88, Annex F, at 7.

[286] E-mail from Henri Steenkamp, CFO, MF Global, to Jon Corzine, CEO, MF Global (Oct. 6, 2011, 9:05 p.m.) [hereinafter Steenkamp E-mail].

[287] *Id.*

[288] *Id.*

[289] *Id.*

Dispute with FINRA

In light of the Eurozone debt crisis, FINRA adopted a heightened focus on the European sovereign debt exposure for firms it supervised.[290] In September 2010, FINRA contacted MF Global to determine whether the company had sovereign debt in its inventory.[291] MF Global answered that it did not, even though it had begun to enter into the European RTM trades.[292] FINRA first learned of the RTM trades shortly after reviewing MFGI's March 2011 FOCUS report.[293] In particular, FINRA observed that MFGI reported a $38 million loss for the month of March, which was considerably larger than the company reported in prior months.[294] When FINRA contacted MFGI to ascertain the reason for the large loss, it learned that the company had reallocated a portion of the revenue it earned from the European RTM trades to MFGUK in order to better reflect the market value of the services that MFGUK performed in managing the trades.[295] FINRA then reviewed MFGI's Annual Audited Financial Statements, filed in May 2011.[296] These statements contained written descriptions of the trades.[297]

After reviewing MFGI's disclosures, FINRA, in consultation with staff from the SEC and CBOE, concluded that the SEC's net capital rule required MFGI to take "capital charges" against its European sovereign bond positions as if they were on the company's balance sheet,

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[290] Dec. 15, 2011 Hearing, *supra* note 50, at 155 (statement of Richard G. Ketchum, Chairman and CEO, FINRA).
[291] Interview by O&I Subcomm. staff with FINRA personnel, in Wash., D.C. (June 27, 2012) [hereinafter Interview with FINRA].
[292] *Id.*; Dec. 15, 2011 Hearing, *supra* note 50, at 155 (statement of Richard G. Ketchum, Chairman and CEO, FINRA).
[293] Interview with FINRA, *supra* note 291.
[294] *Id.* MF Global reported $6.7 million and $2.9 million losses in Jan. and Feb. respectively.
[295] *Id.* MFGI did not record the expense associated with allocating RTM revenue to MFGUK as a discrete, expressly captioned line-item on the income statement in the company's March 2011 FOCUS report. Rather, after performing a "variance analysis" at line 14145 of the report, FINRA determined that MFGI incurred over $59 million in increased expenses for "Commissions and Clearance Paid to All Other Brokers" in Mar. as compared to Feb. This increase represented the majority of the overall increase in the expenses that MFGI incurred in Mar.
[296] PwC, Annual Audited Financial Statement, at 9 (quarter ended Mar. 31, 2011).
[297] Annual Audited Financial Statements are filed by broker-dealers pursuant to SEC Rule 17a-5, though they are similar in many respects to 10-K annual reports, which are filed by all public companies. Interview with FINRA, *supra* note 291.

notwithstanding that the bonds had been accounted for as "sold," in accordance with GAAP.[298] FINRA believed that for purposes of determining whether the company possessed sufficient liquid assets to satisfy its obligations in the event of liquidation, the SEC's net capital rule required the bonds collateralizing the European RTM trades to be considered in the calculation of MF Global's level of net capital, regardless of how they were treated for accounting purposes.[299] While recognizing the bonds as assets would not affect the company's equity, MF Global would have to treat the bonds as non-convertible debt securities for purposes of deducting haircuts in the company's net capital computation.[300]

MF Global pressed FINRA to demonstrate why the net capital rule required the company to take a capital charge on the European bonds that collateralized the RTMs.[301] In meetings with FINRA staff members, MF Global argued that the capital treatment of its European RTM trades should be governed by previous guidance issued by the SEC, which did not require companies to take haircuts or capital charges on U.S. Government securities used to collateralize RTMs, given that they present no risk of default and are highly liquid.[302] MF Global believed that this guidance should also govern the capital treatment of the European bonds that collateralized its RTMs because the risk that European nations would default on the bonds the company held was virtually non-existent.[303] MF Global additionally argued that it should not have to record a capital charge because GAAP rules allowed it to derecognize the bonds from its balance sheet.[304]

[298] Dec. 15, 2011 Hearing, *supra* note 50, at 155 (statement of Robert Cook, Dir., Div. of Trading and Markets, SEC).
[299] Interview with FINRA, *supra* note 291.
[300] *Id.*
[301] *Id.*
[302] See SEC Staff Guidance to NYSE, Repurchase Transactions to Maturity (No. 97-6, Oct. 1997).
[303] Interview with FINRA, *supra* note 291; Dec. 15, 2011 Hearing, *supra* note 50, at 155 (statement of Richard G. Ketchum, Chairman and CEO, FINRA).
[304] Interview with FINRA, *supra* note 291.

FINRA staff members responded by noting that MF Global had indicated in its regulatory filings that the company retained the default risk on its European bonds and that this risk was non-trivial.[305] FINRA pointed to the fact that LCHC, through which MF Global cleared its European RTM trades, required MF Global to post significant margin to support the positions.[306] In FINRA's view, the SEC's guidance for RTMs backed by U.S. Treasuries was inapplicable in determining the capital treatment of the European bonds.[307]

When FINRA refused to change its position, Corzine and other MF Global representatives took their case to the SEC, arguing that FINRA was re-interpreting the rule and that a capital charge was not required.[308] In MF Global's view, the extended discussions about the RTMs' capital treatment reflected the uncertainty surrounding a complex issue.[309] SEC staff members, however, were surprised to learn that MF Global had not taken haircuts on its European bonds, and found the company's representatives to be unfamiliar with published SEC guidance interpreting the net capital rule.[310] SEC staff believed that the capital charge was "cut and dry" and that there was never any doubt about what the net capital rule required.[311] In the SEC's view, MF Global should have, at a minimum, asked the agency about the regulatory net capital treatment of the European bonds before entering into the European RTM trades.[312]

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[305] *Id.*
[306] *Id.*
[307] *Id.*
[308] Because it was unusual for the CEO to personally present his company's position on such a matter, SEC staff were "surprised" that Corzine personally attended the meeting. Interview by Subcomm. on O&I staff with SEC personnel, in Wash., D.C. (June 29, 2012) [hereinafter June 2012 Interview with SEC]; *see also* E-mail from Neil Hatton, MFGUK, to Henri Steenkamp, CFO, MF Global (Sept. 1, 2011, 01:00 p.m.) (characterizing MF Global's position that regulators were reinterpreting the net capital rule).
[309] E-mail from Laurie Ferber, Gen. Counsel, MF Global, to Laurie Ferber (Sept. 6, 2011, 09:32 a.m.).
[310] June 2012 Interview with SEC, *supra* note 308.
[311] *Id.*
[312] *Id.* News of the exposure, without haircuts on the bonds, "raised [the] eyebrows" of some SEC staff members.

Accordingly, the SEC agreed with FINRA that MF Global was required to take a capital charge against its European RTM positions.[313]

[313] *Id.*

The Collapse of MF Global

FINRA Imposes Capital Charge

When it became clear to MF Global that the SEC agreed with FINRA's interpretation of the net capital rule, MF Global sought to negotiate the size of the capital charge that FINRA would impose.[314] In an August 11, 2011 memorandum to FINRA, MFGI requested that, for purposes of imposing haircuts under the net capital rule, the Belgian, Italian, and Spanish bonds collateralizing its RTM portfolio be treated as if they were U.S. bonds, and that its lower-rated Irish and Portuguese bonds be treated as if they were corporate bonds.[315] Additionally, MFGI argued that the standard haircuts set forth in the net capital rule encompassed several risk components such as default, settlement, market, liquidity, reputational, and legal risk, and because the only risk facing the company's bonds was default risk, the haircuts FINRA imposed on its Belgian, Italian, and Spanish bonds should be discounted by 80 percent to reflect only the default risk component.[316] Based on this requested treatment, MFGI calculated that the regulatory capital charge imposed by FINRA would total $55.8 million.[317]

FINRA rejected MFGI's proposed capital treatment, indicating that there was no justification for treating bonds within the company's portfolio as different types of securities based on either the country of issuance or credit rating, nor was there any justification for imposing haircuts smaller than those required under the net capital rule.[318] FINRA categorized

[314] Interview with FINRA, *supra* note 291.
[315] See Memorandum from MFGI to FINRA (Aug. 11, 2011). Under the net capital rule, the haircuts imposed on U.S. bonds ranges between 0 and 1.5 percent, depending on the maturity date, and the haircuts imposed on corporate bonds is two percent for bonds with a less than one year to maturity and three percent for bonds with between one and two years to maturity. MFGI's Belgian, Italian, and Spanish bonds were rated AA+, AA-, and AA+, and its Irish and Portuguese bonds were rated BBB+ and BBB-, the latter being the lowest investment grade category.
[316] *Id.*
[317] *Id.*
[318] Interview with FINRA, *supra* note 291.

the bonds collateralizing MFGI's European RTM portfolio as nonconvertible debt securities and calculated regulatory haircuts of approximately $257 million.[319]

In discussions with FINRA, Steenkamp indicated that infusing capital into MFGI could impede MF Global's growth opportunities, which FINRA understood to be a reference to the company's strategic plan.[320] Nevertheless, in anticipation of the charge, MFGI took steps to ensure that it would have net capital sufficient to exceed both the required minimum level and FINRA's early warning notification level.[321] MF Global increased MFGI's excess net capital by $183 million to $287 million as of August 24, 2011, which ensured that the subsidiary had adequate capital after accounting for the effect of FINRA's capital charge.[322] However, because FINRA applied the capital charge retroactively, FINRA rules required MFGI to amend its most recent FOCUS report to reflect a $150 million deficiency in net capital for the month of July.[323] As a result, the company was also required to file notices of net capital deficiency with the SEC and CFTC, and MF Global was required to amend its quarterly 10-Q filing for the quarter ended June 30, 2011.[324] In the amended 10-Q filed on September 1, MF Global disclosed that FINRA had required the company to "modify its capital treatment of certain repurchase transactions to maturity collateralized with European sovereign debt and thus increase its required net capital pursuant to SEC Rule 15c3-1" but that it had "net capital sufficient to exceed both the required minimum level and FINRA's early-warning notification level."[325] MF Global further stated that

[319] E-mail from Edith O'Brien, Ass't. Treasurer, MF Global, to David Dunne, MF Global (Aug. 25, 2011, 06:34 a.m.).
[320] Interview with FINRA, *supra* note 291.
[321] Letter from Michael Bolan, Global Product Controller, MF Global Inc., to Michael Macchiaroli, Assoc. Dir., Div. of Trading and Markets, SEC, at 1 (Aug. 25, 2011) [hereinafter MFGI letter to SEC].
[322] *Id*.
[323] Interview with FINRA, *supra* note 291.
[324] MFGI letter to SEC, *supra* note 321 *and* Dec. 15, 2011 Hearing, *supra* note 50, at 156 (statement of Richard G. Ketchum, Chairman and CEO, FINRA).
[325] MF Global Holdings Ltd., Amendment No. 1, Form 10-Q/A for the Quarter Ended June 30, 2011 at 1 (Sept. 1, 2011).

it did not believe that the increase in net capital would have a "material adverse impact on its business, liquidity or strategic plans" and that it expected that "its regulatory capital requirements will continue to decrease as the portfolio of these investments matures."[326]

The CFTC first learned of FINRA's capital charge on August 25, 2011 when MF Global sent its notice of net capital deficiency to the agency.[327]

Media Reports Capital Charge

Although FINRA's capital charge against MFGI became public on September 1, 2011, when MF Global filed its amended 10-Q, news of the charge did not become widely known until seven weeks later. On the morning of October 17, the Wall Street Journal published an article detailing the capital charge and noted that "the move underscores regulators' growing concerns about the exposure of financial firms to sovereign debt" and "highlights the potential perils surrounding the aggressive strategy employed by Mr. Corzine, the firm's chief executive."[328] Investors reacted to the news: MF Global's share prices fell 6 percent to close the day's trading at just $3.71.[329]

The news came at an especially bad time for MF Global. The company was set to release its quarterly earnings report on October 27, which would announce a net loss of $191.6 million, the company's worst performance ever, and had scheduled meetings with the ratings agencies that week to discuss its performance.[330] After meeting with Moody's on Friday, October 21, MF

[326] *Id.*
[327] Interview with CFTC, *supra* note 117; E-mail from Jill Sommers, Commissioner, CFTC, to O&I Subcomm. staff (Sept. 7, 2012, 11:32 a.m.).
[328] Aaron Lucchetti, *MF Global Told to Boost Capital*, WALL ST. J., Oct. 17, 2011 (http://online.wsj.com/article/SB10001424052970203658804576635361082548304.html) (last visited Oct. 24, 2012) [hereinafter Lucchetti Article].
[329] MF Global Stock Prices, *supra* note 46.
[330] *See* Lucchetti Article, *supra* note 328; MF Global Fin. Performance, *supra* note 46.

Global anticipated that Moody's would likely downgrade the company's credit rating.[331] Over the weekend, Steenkamp pleaded with Moody's not to downgrade the company, insisting that its "capital and liquidity has never been stronger" and that it "is in its strongest position ever as [a] public company."[332]

MF Global's Final Days

Monday, October 24, 2011

Steenkamp's weekend plea went unanswered. On October 24, 2011, Moody's downgraded MF Global's credit rating to "Baa3," one notch above junk status, explaining that "[t]he rating action reflects Moody's view that the current low interest rate environment and volatile capital markets conditions make it unlikely that MF Global, in the near term, will be able to achieve the financial targets that Moody's had previously specified were required for it to maintain its Baa2 rating."[333] Moody's also noted that MF Global's exposure to "European sovereign debt in peripheral countries and its need to inject capital into its broker-dealer subsidiary to rectify a regulatory capital shortfall highlights the firm's increased risk appetite and raises questions about the firm's risk governance."[334] Moody's analysts had recently discovered MF Global's position in European RTM trades when Moody's downgraded the company.[335] Moody's also placed MF Global's rating under review for possible further downgrade.[336]

Later that day, Corzine addressed MF Global employees in an e-mail stating: "While I am disappointed by this action, it bears no implications for our clients or the strategic direction

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[331] E-mail from Henri Steenkamp, CFO, MF Global, to Al Bush, Moody's (Oct. 22, 2011, 11:33 p.m.).
[332] *Id.*
[333] Press Release, Moody's, Moody's Rating Action: Moody's downgrades MF Global to Baa3; reviews for further downgrade (Oct. 24, 2011).
[334] *Id.*
[335] Moody's Compliance – Rating Committee Addendum (Oct. 27, 2011).
[336] Press Release, Moody's, Moody's Rating Action: Moody's downgrades MF Global to Baa3; reviews for further downgrade (Oct. 24, 2011).

of MF Global…Many of our peers are experiencing similar changes to their counterparty credit ratings…I believe in our strategy, our employees and our path ahead."[337] To calm worried investors, Corzine announced that the company would be moving up Thursday's planned earnings announcement to Tuesday morning at 7:30 a.m.[338]

Tuesday, October 25, 2011

During the earnings call on Tuesday morning, Corzine and Steenkamp disclosed the company's quarterly loss and sought to reassure analysts about MF Global's prospects. Corzine said that although there were "no excuses" for the company's performance, he remained committed to his strategic plan, and that "the long-term return profile of an investment bank is attractive."[339] Additionally, he minimized the significance of FINRA's capital charge, stating that the action was not specific to MF Global in relation to capital and that the company was "dealing with an actual regulatory reinterpretation of the haircuts [the regulators] apply" to European sovereign debt holdings.[340] Corzine also sought to clear up "clouded perceptions" about the company's European RTM portfolio, asserting that the trades had "relatively little underlying principal risk" and had realized "zero" loss.[341] "On a personal note," Corzine added, "our positions and the judgment about risk mitigation steps are my personal responsibility and a prime focus of my attention."[342] Regarding the Moody's credit downgrade, Corzine stated that "we are disappointed with the action quite obviously" but that "we think we can grow our earnings" and that MF Global was continuing to work with Moody's in its credit assessment by

[337] E-mail from Jon S. Corzine, CEO, MF Global, to MF Global staff (Oct. 24, 2011, 06:26 p.m.).
[338] Shannon D. Harrington and Matthew Leising, *MF Global May Be Lowered to Junk by Moody's as Corzine Adds Trading Risk*, BLOOMBERG, Oct. 24, 2011 (http://www.bloomberg.com/news/2011-10-24/mf-global-may-be-lowered-to-junk-by-moody-s-as-corzine-adds-trading-risk.html) (last visited Oct. 24, 2012); MF Global Holdings Earning Call FY12 Q2 (Oct. 25, 2011).
[339] MF Global Holdings Earning Call FY12 Q2 (Oct. 25, 2011).
[340] *Id.*
[341] *Id.*
[342] *Id.*

"walking through with them…some of the strategic actions we're thinking about," including increasing capital through "asset sales of non-core holdings."[343] Steenkamp closed his explanation of the company's financial condition by stating, "I'm proud to say that our capital structure has never been stronger," and that "despite these uncertain and volatile times, we feel good about…our liquidity position as well as the strategic direction and progress against the plan."[344]

Corzine's and Steenkamp's assurances to analysts, however, did little to quell investor panic. When the NYSE opened for trading that morning, the trading volume for MF Global's stock surged to more than eleven times the volume of the day before. The stock, which opened at $3.31, traded as low as $1.75 during the day and closed at just $1.86, marking a decline of approximately 44 percent.[345]

MF Global's customers and counterparties also reacted to the earnings news, and as the crisis deepened, MF Global faced a liquidity drain of crisis proportions.[346] Several of the company's biggest securities and futures customers closed their accounts or withdrew funds.[347] MF Global's counterparties to its European RTM trades began to demand additional margin and deeper haircuts on bonds posted as collateral.[348] One counterparty, HSBC pulled MF Global's line of credit and ordered the company to wind up its business with the bank by the end of the year.[349]

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[343] *Id.*
[344] *Id.*
[345] MF Global Holdings, Ltd. stock prices for Oct. 25, 2011. http://finance.yahoo.com/q/hp?s=MFGLQ&a=09&b=25&c=2011&d=09&e=25&f=2011&g=d (last visited Oct. 24, 2012).
[346] MFGI Trustee Report, *supra* note 123, at 90.
[347] MFGI Trustee Report, *supra* note 123, at 145-46, 153.
[348] Dec. 15, 2011 Hearing, *supra* note 50, at 141 (testimony of Jon S. Corzine, CEO, MF Global).
[349] E-mail from Victoria Foster, European Head of Equity Finance, MFGUK, to Mark Whitehead, MFGUK, et al. (Oct. 25, 2011, 03:51 p.m.).

Wednesday, October 26, 2011

On October 26, 2011, S&P placed MF Global's BBB- credit rating on "CreditWatch Negative," noting that "continued volatility in the capital markets and low interest rates could further harm MF Global's ability to generate capital."[350] S&P also noted that the company's exposure to European RTM trades was "very high compared to the company's loss absorbing capital base," though S&P mistakenly asserted that the European RTM trades were "entered…as a means to facilitate client trades," rather than proprietary investments.[351] S&P believed that MF Global's future business plans "could entail increased risk taking as it transforms itself into a full-service investment bank."[352]

That day, consistent with the Alternative Method, MFGI reported excess funds of approximately $1 billion in segregated and secured accounts as of the close of business on Tuesday, though the company's internal records showed that it had only $21.5 million of its own funds in the accounts. Edith O'Brien, the company's assistant treasurer, authorized $615 million in intraday transfers from the company's FCM customer accounts.[353] Because these transfers exceeded the amount of MFGI's "Firm Invested in Excess" funds, the difference came from customer funds.[354]

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[350] S&P, Research Update: MF Global Holdings Ltd. Rating Placed on CreditWatch Negative (Oct. 26, 2011) [hereinafter S&P Research Update].
[351] S&P Jan. 17, 2012 letter, *supra* note 21, at 6; S&P Research Update, *supra* note 350, at 2. The CreditWatch action signaled to the market that S&P believed there was a substantial likelihood of a rating action for MF Global within 90 days. *See* S&P, General Criteria: Use of CreditWatch and Outlooks, at 3 (Sept. 14, 2009).
[352] S&P Research Update, *supra* note 350, at 2.
[353] MFGI Trustee Report, *supra* note 123, at 102-03.
[354] *Id.* In addition, an MF Global employee gave three computer discs to a CFTC employee at 5:30 p.m. on Fri., Oct. 28, which contained information relevant to the computation of balances in MFGI's segregated accounts. While the CFTC did not comprehensively review the disks when it received them, it later examined MFGI's records, including the data on the disks, and determined there was a deficiency in customer funds in segregated accounts as of Wed., Oct. 26. "Implementing Derivatives Reform: Reducing Systemic Risk and Improving Market Oversight," Senate Committee on Banking, Housing and Urban Affairs, 112th Congress, 2d Session, May 22, 2012 (CFTC Responses for the Record to Senator Shelby).

The SEC advised MFGI that it wanted to meet with the company's managers the next day to discuss liquidity, funding, financial statement condition, and regulatory computations, and that the CFTC would also participate in the meeting.[355] MF Global also held a conference call with FINRA and CBOE to discuss similar issues.[356]

Thursday, October 27, 2011

On Thursday, Moody's and Fitch both downgraded MF Global's credit rating to junk status.[357] Moody's cited "weak core profitability" that had "contributed to [MF Global] taking substantial risk in the form of its exposure to European sovereign debt in peripheral countries."[358] Fitch cited continued challenges in reducing the company's leverage and achieving sustained profitability, especially because low interest rates reduced the revenue generated by MF Global's commodity business.[359] Fitch also stated that "significant headwinds" made it more difficult for the company to complete its "strategic transformation from a pure broker to a broker-dealer and, longer term, to a full investment bank without [taking on] outsized incremental risk."[360] Additionally, Fitch said that "increased risk taking activities" had left the company "vulnerable to potential credit deterioration and/or significant margin calls."[361]

These downgrades sparked increasing margin calls and further contributed to an exodus of customers. MF Global had to draw $805 million from its liquidity facility, leaving the credit

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[355] Mar. 28, 2012 Hearing, *supra* note 179, at 6-7 (statement of Laurie Ferber, Gen. Counsel, MF Global); Interview by O&I Subcomm. staff with SEC personnel, in Wash., D.C. (Mar. 15, 2012) [hereinafter Mar. 2012 Interview with SEC].
[356] Mar. 28, 2012 Hearing, *supra* note 179, at 6-7 (statement of Laurie Ferber, Gen. Counsel, MF Global); E-mail from Matt McGarvey, Branch Chief, 17H Broker Dealer Operations, Trading and Markets Div., SEC, to Robert Cook, Dir. Trading and Markets Div., SEC (Dec. 9, 2011, 02:21 p.m.).
[357] Press Release, Moody's, Ratings Action: Moody's downgrades MF Global to Ba2; reviews for further downgrade (Oct. 27, 2011); William Spain, *Fitch Ratings Downgrades MF Global*, WALL ST. J. MARKET WATCH, Oct. 27, 2011 (http://articles.marketwatch.com/2011-10-27/news/30903166_1_fitch-ratings-downgrades-issuer-default-ratings) (last visited July 21, 2012) [hereinafter Spain Article].
[358] Spain Article, *supra* note 357.
[359] *Id.*
[360] *Id.*
[361] *Id.*

line totally depleted.[362] LCHC demanded an additional $211 million in margin to cover the company's European RTM trades.[363] The Depository Trust & Clearing Corporation, another clearing house used by MFGI, reduced the amount of credit it extended to the company to settle trades by $234 million.[364] Similarly, the Fixed Income Clearing Corporation increased MFGI's margin requirement and withheld cumulative excess margin of approximately $108.9 million.[365] Counterparties also increased haircut demands, and some counterparties stopped trading with MFGI altogether, leaving $606 million of the company's securities "in the box," meaning that the company could not find a counterparty to lend it money against these securities in a repo transaction.[366] Customers began withdrawing funds from the company's customer accounts.[367]

On Thursday, the SEC and the CFTC met with MF Global executives to conduct a risk review.[368] The CME Group also sent members of its audit department to review the segregated and secured account balance statements that MFGI had filed as of close of business on Wednesday.[369] The CME Group sent a letter to Serwinski, instructing her that "effective immediately," any equity withdrawals "must be approved in writing by CME Group's Audit Department."[370]

Late on Thursday evening, JPMorgan Chase bank (JPMC) began putting all of MF Global's accounts on "debit alert."[371] Once on debit alert, JPMC would execute funds transfers

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[362] MFGI Trustee Report, *supra* note 123, at 94.
[363] *Id.* at 96.
[364] *Id.*
[365] *Id.*
[366] *Id.*
[367] Elkind Burke article, *supra* note 88. By the end of the week, customers had withdrawn $1 billion in funds from the company's customer accounts.
[368] Dec. 15, 2011 Hearing, *supra* note 50, at 67 (testimony of Dan M. Berkovitz, Gen. Counsel, CFTC); *Id*, at 119 (statement of Robert Cook, Dir., Div. of Trading and Markets, SEC).
[369] *Id.*
[370] Letter from Michael A. Procajlo, Director, Audits, CME Group, to Christine Serwinski, CFO, MFGI (Oct. 27, 2011).
[371] Mar. 28, 2012 Hearing, *supra* note 179, at 4 (statement Diane M. Genova, Deputy Gen. Counsel, JP Morgan Chase [hereinafter JPMC]).

as instructed by MF Global only after determining funds present in the account to be debited were adequate to support the requested transfer.[372] As part of the debit alert process, JPMC terminated its uncommitted intraday credit lines to MF Global.[373] The bank's intraday credit lines to MF Global were similar to overdraft protection, and provided unsecured liquidity to the company in support of different types of funds transfers from MF Global's cash accounts at JPMC.[374] The debit alert "caused significant delay in the settlement of [certain cash] transactions" instructed by MF Global, "even when [JPMC] ultimately determined that MFGI had 'good funds' on deposit to permit the transaction to settle."[375] JPMC also sent a team to MF Global's New York headquarters to aid the company's efforts to unwind its securities lending arrangements in order to generate liquidity.[376]

Friday, October 28, 2011

In the prior day's confusion, MFGUK overdrew several of its accounts with JPMC by approximately $175 million.[377] MF Global was trying to sell roughly $5 billion in bonds with the help of JPMC to shrink the company's balance sheet and generate liquidity, but JPMC informed Corzine that "they would not engage in those transactions until the overdrafts in

[372] *Id.*
[373] *Id.*
[374] Interview by O&I Subcomm. staff with JPMC representatives, in Wash., D.C. (Mar. 9, 2012) [hereinafter Interview with JPMC]; *see also* MFGI Trustee Report, *supra* note 123, at 128.
[375] MFGI Trustee Report, *supra* note 123, at 128.
[376] Mar. 28, 2012 Hearing, *supra* note 179, at 4 (statement Diane M. Genova, Deputy Gen. Counsel, JPMC).
[377] E-mail from Vinay Mahajan, Global Treasurer, MF Global, to Russell Haley, MF Global, Edith O'Brien, Ass't. Treasurer, MF Global, cc: Jon Corzine, CEO, MF Global (Oct. 28, 2011, 08:27 a.m.).

London were cleaned up."[378] Corzine therefore contacted MF Global's Chicago office and asked them to resolve the overdrafts.[379]

To cover the overdrafts, O'Brien approved and processed a $200 million wire transfer from one of MFGI's customer segregated accounts to one of the company's "house" accounts.[380] O'Brien then authorized a $175 million transfer from the same "house" account to an MFGUK account at JPMC in London.[381] O'Brien noted in an e-mail that the $175 million transfer to pay the JPMC overdraft was "per [Jon Corzine's] direct instructions."[382] When O'Brien authorized the $200 million wire transfer, she had not yet received the segregation statement detailing customer fund balances for the previous day because Matthew Hughey, MF Global's Regulatory Capital Controller, was still preparing them.[383]

Because JPMC was the depository bank for certain of MF Global's customer funds, it subsequently observed that MF Global had moved $200 million from one of the company's customer accounts to its "house" account just before MF Global transferred $175 million from

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[378] Dec. 15, 2011 Hearing, *supra* note 50, at 11 (testimony of the Hon. Jon Corzine, CEO, MF Global). In an e-mail to two MF Global employees, Vinay Mahajan explained that JPMC was "holding up vital business in the U.S. as a result" of the overdrawn UK account. E-mail from Vinay Mahajan, Global Treasurer, MF Global, to Jon Ferber, MF Global, Russell Haley, MF Global (Oct. 28, 2011, 01:35 p.m.). The employees were to confirm that the overdraft had been covered. *Id*.

[379] Dec. 15, 2011 Hearing, *supra* note 50, at 11 (testimony of the Hon. Jon Corzine, CEO, MF Global).

[380] E-mail from Edith O'Brien, Ass't. Treasurer, MF Global, to Laurie Ferber, Gen. Counsel, MF Global (Oct. 28, 2011, 05:37 p.m.) [hereinafter O'Brien E-mail Oct. 28, 2011, 05:37 p.m.]. A company's house account is an account designated for a company's own funds.

[381] E-mail from Edith O'Brien, Ass't Treasurer, MF Global, to Laurie Ferber, Gen. Counsel, MF Global (Oct. 28, 2011, 09:43 p.m.).

[382] E-mail from Edith O'Brien, Ass't Treasurer, MF Global, to Russell Haley, MF Global (Oct. 28. 2011, 01:34 p.m.).

[383] O'Brien E-mail Oct. 28, 2011, 05:37 p.m., *supra* note 380; Interview by O&I Subcomm. staff with Matthew Hughey, Controller, Fin. Regulatory Group, MF Global, in Wash., D.C. (May 29, 2012) [hereinafter Interview with Hughey]. The most recent statement reported excess funds of approximately $116 million in segregated accounts as of Wednesday and, on Thursday, the company had returned a total net amount of approximately $375 million to the accounts. *See* MFGI Trustee Report, *supra* note 123, at 107, fn. 117, at 109, fn. 79. In fact, balances in the company's segregated accounts were not as O'Brien may have understood; subsequent analysis by the MFGI trustee determined there was a deficiency in customer funds on deposit in segregated accounts as of the close of business on Wednesday and Thursday. *Id.* at Annex D (detailing $298 million deficiency as of Wednesday and $413 million deficiency as of Thursday).

that "house" account to cover the overdraft.[384] JPMC's Chief Risk Officer, Barry Zubrow, called Corzine to seek an assurance that the money transferred from the customer segregated account did not represent customer funds.[385] The bank then sent Corzine a letter, to be signed by O'Brien, that sought an assurance that all transfers from MF Global's segregated customer accounts complied with the CFTC's customer protection rules.[386] In response to requests from MF Global, JPMC revised the letter twice to narrow its focus to the transfers in question.[387] However, despite MF Global staff's oral assurances to JPMC that O'Brien would sign the narrowed version of the letter, neither O'Brien nor any other representative of MF Global ever did so.[388]

Hughey completed his preliminary review of the segregated and secured calculations as of the close of business on Thursday. He was surprised to find that the company was deficient in its segregated accounts by over $300 million. Hughey initially believed the apparent deficiency resulted from a failure to account for several wire transfers. He contacted representatives of MF Global's Treasury department to reconcile the numbers, but found them to be atypically unresponsive. Given the fast-approaching noon deadline for submitting the MFGI's segregated and secured statements to regulators and the concern surrounding the large deficiency in segregated accounts, Hughey and his colleague, Philip Cooley, approached O'Brien to discuss

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[384] Mar. 28, 2012 Hearing, *supra* note 179, at 7 (statement of Diane Genova, Deputy Gen. Counsel, JPMC).
[385] Interview with JPMC, *supra* note 374.; *see also* Mar. 28, 2012 Hearing, *supra* note 179, at 7 (statement of Diane Genova, Deputy Gen. Counsel, JPMC).
[386] E-mail from Donna Dellosso, Managing Dir., TSS Risk Management, JPMC, to Jon Corzine, CEO, MF Global (Oct. 28, 2011, 02:28 p.m.).
[387] *Id.*
[388] Mar. 28, 2012 Hearing, *supra* note 182, at 139 (testimony of Dianne Genova, Deputy Gen. Counsel, JPMC). *See Id.* at 51 (testimony of Laurie Ferber, Gen. Counsel, MF Global) ("My understanding was JPMorgan confirmed that they were interested in two transfers…and on inquiry, [I] thought it would be better if [the letter] was limited to that. We would be able to make that [representation]. I…asked them to…limit the letter to what they needed and we would get it signed"); *Id.* at 139 (testimony of Dianne Genova, Deputy Gen. Counsel, JPMC) ("I personally had conversations with both Ms. Ferber and her deputy…who gave me oral assurances that they knew the rules, they were in compliance with the rules, and that—and when we finally revised the letter to only refer to the two transfers that I…really had some concerns about, that in fact the letter would be signed"); E-mail from Dennis Klejna, MF Global, to Laurie Ferber, Gen. Counsel, MF Global (Oct. 28, 2011, 08:08 p.m.).

the problem. When Hughey and Cooley arrived at O'Brien's office to discuss the matter, she said that she was very busy. The two men found O'Brien to be aloof and non-responsive to their concerns about the deficiency in the segregated customer accounts. O'Brien asked Jason Chenoweth, an accountant who worked for her, to handle the matter.[389]

Chenoweth ushered Hughey and Cooley into a separate room where they worked to reconcile the deficiency. After reviewing the wire transfers, Chenoweth determined the deficiency was a result of five transactions – totaling $540 million – that were booked incorrectly. Hughey and Cooley manually adjusted the segregated statement by $540 million, which resulted in a reported excess of $200 million in the segregated statement.[390]

Shortly after Hughey made the manual adjustment, he contacted Serwinski, who was on vacation, to inform her that Chenoweth had reconciled the deficiency in the segregated account, but stated that he had not yet received backup documents to support Chenoweth's conclusions.[391] After speaking with Serwinski, Hughey filed the company's segregated and secured statements showing the excess balance of roughly $200 million.[392] Serwinski then told Hughey that he and his team must report to the office early Saturday morning to get a head-start on preparing the Friday close of business segregated and secured statements.[393]

At approximately 6:00 p.m. on Friday night, the New York Fed suspended MF Global from conducting new business as a primary dealer.[394]

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[389] Interview with Hughey, *supra* note 383.
[390] *Id.* Chenoweth's determination that the five transactions were incorrectly booked later turned out to be erroneous. MFGI Trustee Report, *supra* note 50, at 112.
[391] *Id.*
[392] Telephone Interview with Serwinski, *supra* note 278.
[393] Interview with Hughey, *supra* note 383.
[394] Dec. 15, 2011 Hearing, *supra* note 50, at 13 (testimony of Thomas C. Baxter, Jr., Gen. Counsel, NYFRB).

Saturday, October 29, 2011

On Saturday morning, Hughey and his team prepared initial drafts of the segregated and secured statements for Friday that showed a deficit in segregated customer funds of over $900 million.[395] MF Global's Treasury Department assured Serwinski's staff that the shortfall must have resulted from reconciliation errors and that the customer accounts were not undersegregated.[396] The company did not inform its regulators about the apparent shortfall in segregated customer funds and its efforts to reconcile the shortfall.[397]

Meanwhile, MF Global's senior management was attempting to sell all or part of the company and to unwind its proprietary investments, including the European RTM trades.[398] At 5:30 p.m., Corzine updated regulators about the company's negotiations with potential purchasers and the company's asset sales.[399] Corzine had identified Interactive Brokers, LLC as a potential buyer, and executives for both companies worked through the weekend to negotiate the terms of a deal.[400]

Sunday, October 30, 2011

Throughout the weekend, CFTC Chairman Gary Gensler and CFTC staff expressed concern that the amounts on deposit in MF Global's foreign secured accounts were less than what the company owed to commodity customers who traded on foreign exchanges.[401] Because MF Global used the "Alternative Method" of calculating funds to set aside in those accounts, it

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[395] Mar. 28, 2012 Hearing, *supra* note 179, at 48 *(*testimony of Christine Serwinski, North American CFO, MF Global).
[396] *Id.* at 3 (statement of Christine Serwinski, North American CFO, MF Global).
[397] *See id.* at 48-49 (testimony of Christine Serwinski, North American CFO, MF Global); Mar. 28, 2012 Hearing, *supra* note 179, at 7 (testimony of Laurie Ferber, Gen. Counsel, MF Global).
[398] Dec. 15, 2011 Hearing, *supra* note 50, at 141-142 (testimony of Jon Corzine, CEO, MF Global, Inc.).
[399] E-mail from Grace Vogel, FINRA, to Richard Ketchum, FINRA, et al (Oct. 29, 2011, 07:10 p.m.).
[400] *Id.* JPMC told MF Global's financial advisor that it was not interested in purchasing the company, but might be interested in particular assets or securities portfolios.
[401] *See* E-mail from Gary Gensler, Chairman, CFTC, to Bart Chilton, Commissioner, CFTC (Oct. 30, 2011, 08:05 p.m.); E-mail from Gary Gensler, Chairman, CFTC, to Mark Metjen, CFTC (Oct. 30, 2011, 08:13 p.m.) [hereinafter Gensler E-mail].

did not have to deposit all customer money in the accounts. As a consequence, officials from the CME Group encouraged the company to move more funds into the accounts.[402]

The concern that there would be a shortfall in amounts owed to customers, despite the fact that MF Global was technically in compliance with the rules, prompted Chairman Gensler to remark that the CFTC should consider whether to abandon the Alternative Method.[403] On Sunday, Chairman Gensler wrote to a colleague that he had spent too much of the weekend focused on gaps in part thirty customer funds.[404] He stated MF Global gave him "more reasons…to consider proposals to modify part 30 rules," which governed the safekeeping of funds deposited by customers for trading abroad.[405]

Also on Sunday, CFTC staff recognized that most funds that were held in foreign secured accounts were located with MFGUK and other foreign entities.[406] Of the funds held by MFGUK, CFTC staff wanted to know the amount of the funds, how they were being held by the UK affiliate, if the funds were safe and secure, and the issues with getting the funds back to U.S. customers.[407]

CFTC staff set a 1:00 p.m. deadline on Sunday afternoon for MF Global to provide information on its customer-segregated funds statement for Friday.[408] As of 2:57 p.m., MF Global staff was working to determine the balances and liabilities for the accounts.[409] The CFTC

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[402] *See* E-mail from Michael Procajlo, CME Group, to Thomas Smith, CFTC, et al (Oct. 28, 2011, 12:01 p.m.).
[403] *See* Gensler E-mail, *supra* note 401.
[404] *Id.*
[405] *Id.*
[406] E-mail from Robert Wasserman, Chief Counsel, Div. of Clearing and Risk, CFTC, to Gary Gensler, Chairman, CFTC (Oct. 30, 2011, 02:19 p.m.).
[407] *Id.*
[408] E-mail from Gary Gensler, Chairman, CFTC, to Ananda Radhakrishnan, CFTC, Gary Barnett, CFTC (Oct. 30, 09:56 a.m.); E-mail from Melissa Hendrickson, CFTC, to Thelma Diaz, CFTC, Robert Wasserman, CFTC (Oct. 30, 2011 at 02:54 p.m.).
[409] E-mail from Melissa Hendrickson, CFTC, to Thelma Diaz, CFTC, Robert Wasserman, CFTC (Oct. 30, 2011, 02:57 p.m.).

insisted that MF Global submit information on the segregated statement by 3:00 p.m.[410] The CFTC's Chief Counsel for Clearing and Risk e-mailed MF Global's offices of Treasury and General Counsel stating that the lack of data and supporting documentation was driving adverse inferences.[411] Separately, the CFTC's Chief Counsel wrote to colleagues, "This is NOT good."[412] In an e-mail to the director of the SEC's Division of Trading and Markets, SEC Chairman Mary Schapiro related Chairman Gensler's view that MF Global had not been forthcoming with the CFTC and that, as a result, "they face enforcement."[413]

Around 3:00 p.m., CFTC staff in MF Global's Chicago office saw a draft of the company's customer-segregated funds statements for Friday showing that there was a deficiency in customer accounts.[414] The CFTC staff informed CME Group staff of the apparent shortfall.[415] Throughout the afternoon and evening, MF Global staff and MF Global's regulators worked to obtain more information on the shortfall.[416]

Around 7:00 p.m., MF Global staff spoke with the CFTC and the CME Group.[417] During that discussion, the company attributed the deficiency in the segregated account to an accounting error.[418] Serwinski arrived at the company's Chicago office around 9:00 p.m.[419] As late as 10:00 or 11:00 p.m., Serwinski and O'Brien continued to convey their belief to regulators that

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[410] *Id.*
[411] E-mail from Robert Wasserman, Chief Counsel, Div. of Clearing and Risk, CFTC, to Edith O'Brien, Ass't Treasurer, MF Global, Matthew Hughey, Controller, Fin. Regulatory Group, MF Global, et al (Oct. 30, 2011, 03:40 p.m.).
[412] E-mail from Robert Wasserman, Chief Counsel, Div. of Clearing and Risk, CFTC, to Melissa Hendrickson, CFTC, et al. (Oct. 30, 2011, 02:59 p.m.).
[413] E-mail from Mary Schapiro, Chairman, SEC, to Robert W. Cook, Dir., Div. of Trading and Markets SEC (Oct. 30, 2011, 02:12 p.m.).
[414] *See* CME MF Global Chronology, Week of Oct. 24-31, 2011 [hereinafter CME Chron], at Oct. 30, 2011(stating that at approximately 2:00 p.m. U.S. Central Time CFTC staff member Melissa Hendrickson called Michael Procajlo and told him she had seen a draft of 10/28 segregated statement and that it showed a deficiency in segregated customer funds.).
[415] *Id*.
[416] *See id.* at 5-8.
[417] *Id.* at 6-7, 6:00 p.m.
[418] *Id.*
[419] *Id.* at 7, 8:00 p.m. to 9:00 p.m.

the shortfall was due to an accounting error.[420] By midnight, however, neither the CME Group's auditors nor MF Global staff had been able to identify any error that could explain the deficiency.[421]

Monday, October 31, 2011 and Tuesday, November 1, 2011

At 12:40 a.m. on Monday, October 31, 2011, a CME Group audit-team member e-mailed his colleagues to inform them that Serwinski would "look into coming up with additional funds to transfer into segregation as a contingency" if the accounting error was not identified.[422] Soon thereafter, O'Brien informed Serwinski that she believed that the shortfall in customer segregated funds calculated by the company was not the result of an accounting error and that customer funds were in fact missing from the segregated accounts.[423] O'Brien provided a document that showed the deficiency to be the result of three types of transactions: (1) intra-day loans between MF Global's FCM and its broker-dealer; (2) the funding of client withdrawals from the broker-dealer; and (3) the $175 million transfer to cover MFGUK's overdrawn JPMC account on October 28.[424] Together, these transactions totaled $909 million.[425]

At approximately 2:00 a.m. on Monday morning, O'Brien and Serwinski informed the CME Group that customer funds were missing from segregated accounts.[426] During a

[420] *Id.*
[421] *Id.* at 8, 9 p.m. to 10 p.m.
[422] *Id.*
[423] Mar. 28, 2012 Hearing, *supra* note 179, at 4 (statement of Christine Serwinski, CFO for North America, MF Global).
[424] Telephone Interview by O&I Subcomm. staff with Christine Serwinski, North American CFO, MF Global, in Wash., D.C. (Jan. 5, 2012).
[425] *Id.*
[426] CME Chron, *supra* note 414, at 8, approximately 1 a.m. – 2 a.m.

conference call at approximately the same time, MF Global's senior management also informed the company's regulators of the deficiency.[427]

Before the markets opened on Monday morning, Serwinski sought to identify assets that MFGI could deposit in the company's customer segregated accounts in order to mitigate any shortfall.[428] Among other assets, Serwinski identified approximately $220 million in excess company funds deposited in a reserve account, which the company maintained for its securities customers.[429] Though the SEC had expressed concern to MF Global about the calculation of excess funds in the reserve account and cautioned the company against transferring these funds, MFGI transferred the full amount of the perceived excess to its segregated FCM customer accounts.[430]

On Monday, Matthew Hughey considered whether the $175 million transfer from MFGI to MFGUK affected MFGI's net capital levels.[431] MF Global staff had not consulted with staff from the company's Finance Department, including Serwinski and Hughey, before making the transfer the previous Friday.[432] Upon review, however, Hughey determined that the $175 million transfer was a "non-allowable asset" for purposes of computing MFGI's net capital.[433] Hughey concluded that MFGI's equity (and thus its net capital level) would be reduced to the extent that

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[427] Dec. 15, 2011 Hearing, *supra* 50, at 50 (statement of Robert Cook, Dir., Div. of Trading and Markets, SEC); *Id.*, at 54 (statement of Terrence A. Duffy, Exec. Chairman, CME Group); E-mail from Robert Wasserman, CFTC, to Gary Barnett, CFTC, and Thelma Diaz, CFTC (Oct.31, 2011, 01:58 a.m.).
[428] E-mail from Christine Serwinski, North American CFO, MF Global, to Mike Bolan, MF Global, Henri Steenkamp, CFO, MF Global (Oct. 31, 2011, 10:25 a.m.).
[429] MFGI Trustee Report, *supra* note 123, at 119.
[430] Mar. 2012 Interview with SEC, *supra* note 355; Telephone Interview by O&I Subcomm. staff with FINRA personnel, in Wash., D.C. (Feb. 29, 2012); Telephone interview by O&I Subcomm. staff with FINRA personnel, in Wash., D.C. (Apr. 25, 2012). In an interview with O&I Subcomm. staff, Christine Serwinski stated that, to her recollection, no one communicated to her an instruction or caution from regulators that MF Global not transfer excess funds from the securities customer account.
[431] E-mail from Matthew Hughey, Controller, Fin. Regulatory Group, MF Global, to Dennis Klejna, MF Global, Kemper Cagney, MFGUK (Oct. 31, 2011, 12:50 a.m.) [hereinafter Hughey E-mail].
[432] Interview with Hughey, *supra* note 383; Mar. 28, 2012 Hearing, *supra* note 179 (testimony of Christine Serwinski) (stating that Serwinski would not have made the transfer had she been consulted).
[433] Hughey E-mail, *supra* note 431.

MFGI could not perfect a security interest in collateral owned by MFGUK equal to the value of the transfer.[434] After consulting with colleagues, Hughey concluded that MFGI could assert a lien against MFGUK assets valued at $120 million, and reduced the amount of the "non-allowable asset" accordingly.[435] There is no indication that MF Global staff consulted with MFGI's regulators or SROs before executing the transfer, despite the fact that it potentially affected MFGI's regulatory capital level. There is also no indication that MF Global staff consulted with the CME Group in order to determine whether the transfer constituted an "equity withdrawal" within the meaning of CME's instruction that the company not make any such withdrawal, except with CME's express written permission.[436]

On Tuesday, November 1, an SEC staff member informed a colleague that MFGI had withdrawn the full amount of the perceived excess from the securities reserve bank account.[437] Separately, a FINRA staff member informed colleagues that he understood MF Global to have ignored an instruction from an SEC official not to transfer the funds.[438] In a follow-up e-mail to Chairman Schapiro and others, the director of the SEC's Division of Trading and Markets related that an SEC staff member had heard from MF Global's General Counsel, Laurie Ferber, that the CFTC had pressured MF Global to make the transfer.[439] Chairman Schapiro responded, "Without telling us? That is unacceptable."[440]

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[434] *See id.*
[435] E-mail from Matthew Hughey, Controller, Fin. Regulatory Group, MF Global, to Dennis Klejna (Oct. 31, 2011, 08:02 p.m.).
[436] Interview with CME Group, *supra* note 130. The transfer may have been an "equity withdrawal" to the extent it constituted an unsecured loan.
[437] E-mail from Ethan Allfree, SEC, to Robert Sollazzo, SEC (Nov. 1, 2011, 01:14 p.m.).
[438] E-mail from Jeffrey Fortune, FINRA, to Grace Vogel, Executive V.P., FINRA (Nov. 1, 2011, 02:00 p.m.).
[439] E-mail from Robert W. Cook, Dir., Div. Trading and Markets, SEC, to Mary Schapiro, Chairman, SEC, et al. (Nov. 1, 2011, 02:16 p.m.).
[440] E-mail from Mary Schapiro, Chairman, SEC, to Robert W. Cook, Dir., Div. Trading and Markets, SEC (Nov. 1, 2011, 02:18 p.m.) [hereinafter Schapiro E-mail].

Bankruptcy Filing and Liquidation

When MF Global informed Interactive Brokers of the shortfall of customer funds, the company withdrew from negotiations.[441] With no other alternatives available, MF Global filed for reorganization under Chapter 11 of the Bankruptcy Code in the United States Bankruptcy Court for the Southern District of New York.[442]

Following MF Global's filing, the Securities Investor Protection Corporation commenced a proceeding to liquidate MFGI under the Securities Investor Protection Act.[443] A federal district court judge appointed James W. Giddens as trustee for the liquidation of MFGI.[444] Giddens then hired his law firm, Hughes Hubbard and Reed, LLP as counsel and retained Ernst & Young and Deloitte as consultants and forensic accountants to aid him in investigating the collapse of MFGI and the shortfall in customer funds.[445] Giddens released a report in June 2012 indicating that the shortfall in segregated property is approximately $900 million in domestic accounts (both commodities and securities), plus approximately $700 million in secured accounts related to trading by customers on foreign exchanges.[446] To date, Giddens has recovered approximately 80 percent of the segregated customer property missing from domestic securities accounts and between 60 and 90 percent of the segregated customer property missing from domestic futures accounts.[447] However, he has only recovered approximately five percent of the funds missing

[441] Felix Salmon, *What happened at MF Global?*, REUTERS, Nov. 1, 2011 (http://blogs.reuters.com/felix-salmon/2011/11/01/what-happened-at-mf-global/) (last visited Oct. 24, 2012).
[442] Freeh Report, *supra* note 191. On Nov. 28, 2011, the bankruptcy court approved the U.S. bankruptcy trustee's appointment of Louis J. Freeh as the trustee of MF Global's estate.
[443] *Id.* at 29, 30; *see also* 15 U.S.C. §78aaa et seq.
[444] Order Granting App. to Liquidate MF Global, Inc. pursuant to Securities Investor Protection Act, *Securities Investor Protection Corp. v. MF Global Inc.*, No. 11-02790, at 1 (S.D.N.Y. entered Oct 31, 2011).
[445] Freeh Report, *supra* note 191, at 34.
[446] MFGI Trustee Report, *supra* note 123, at 2.
[447] *Id.* at 8.

from the accounts of customers who traded on foreign exchanges.[448] Most of the remaining shortfall for these customers involves secured property that is being withheld by the Joint Special Administrators of MFGUK. Giddens has filed a claim to recover those funds.[449] However, Giddens and the MFGUK administrators disagree about whether, under U.K. law, Giddens is entitled to have his claim satisfied from the disputed funds before other creditors.[450] The resolution of the disagreement depends on whether, when MFGI deposited funds into MFGUK's account to support client trades, it also transferred ownership of those funds to MFGUK.[451] If it did, the trustee's claim will be satisfied only after the funds have been used to pay certain other creditors.[452] A trial is scheduled for April 9, 2013, in the U.K. to resolve the dispute.[453]

Whether MF Global's customers get all of their property back depends on whether the MFGI trustee can recover funds held by MFGUK; what he can recover through litigation and negotiation with third parties; and on the ability to allocate the property of the MFGI estate to the company's former customers.[454] Because MFGI's other creditors normally would be entitled to have their claims satisfied from MFGI's estate, diverting MFGI property to make customers whole will diminish any recovery that the company's creditors otherwise would realize.[455]

Ongoing Criminal and Civil Investigations and Litigation

MF Global is currently the subject of multiple civil and criminal investigations in jurisdictions around the world. In the U.S., the company and its former employees remain the

[448] Update Regarding June 20, 2012 Interim Distribution, http://dm.epiq11.com/MFG/Project#Section2_35 (last visited July 23, 2012).
[449] MFGI Trustee Report, *supra* note 123, at 157.
[450] *See, e.g.*, Witness Statement of Richard Heis at 7, *In the Matter of MF Global UK Limited*, No. 9527 (2011).
[451] *Id.* at 9.
[452] *Id.* at 8.
[453] Update to 30.7 Customers Regarding UK Legal Proceedings, June 1, 2012, *available at* http://dm.epiq11.com/MFG/Project#Section2_31 (last visited July 23, 2012).
[454] MFGI Trustee Report, *supra* note 123, at 3.
[455] *See In re Griffin Trading Company*, 245 B.R. 291, 296 (N.D. Ill. 2000) (vacated 270 B.R. 882 (N.D. Ill. 2001)).

subject of an investigation by the Department of Justice, led by U.S. Attorneys in Chicago and New York. Additionally, the company is under investigation by both the SEC and the CFTC. MF Global's customers, shareholders, and former employees have commenced litigation against the company and its executives in multiple jurisdictions.[456] Those actions filed pre-petition against the company have been stayed pursuant to the U.S. Bankruptcy Code.[457] However, several post-petition actions filed against Corzine by MF Global's customers and shareholders are currently pending before the United States District Court for the Southern District of New York.[458]

[456] Freeh Report, *supra* note 191, at 87.
[457] *Id.*
[458] *Id*. at 87, 88, 109-111.

Findings and Recommendations

The Subcommittee's yearlong investigation into MF Global's collapse involved over fifty interviews and held three hearings at which it considered the testimony of nineteen witnesses, including MF Global's former senior managers and its principal regulators. Additionally, the Subcommittee examined more than 243,000 documents produced by MF Global, the company's federal commodities and securities regulators, the company's auditor, credit rating agencies, the New York Fed, the self-regulatory organizations, exchanges, and clearing houses to which the company belonged. The following findings and recommendations are based on information gathered by the Subcommittee during the course of its investigation:

Jon Corzine Caused MF Global's Bankruptcy and Put Customer Funds at Risk.

During his nineteen-month tenure as Chairman and CEO of MF Global, Jon Corzine made several fateful decisions, the cumulative effects of which caused MF Global's bankruptcy and jeopardized customer funds.

Soon after joining MF Global, Corzine decided to turn the company into a full-service investment bank. This decision charted a radical new course for the financially troubled company. By expanding MF Global into new business lines without first returning its core commodities business to profitability, Corzine ensured that the company would face enormous resource demands and exposed it to new risks that it was ill-equipped to handle. According to the head of a rival company, Corzine's idea of taking a broker and making it into an investment bank was "an utter impossibility… They do not have the deep culture that Goldman has of

handling risk. You cannot leap with a single bound into proprietary trading and hope to survive intact."[459]

In order to generate much-needed revenue to fund MF Global's transformation, Corzine decided to invest heavily in the sovereign debt of struggling European countries. These investments carried significant default and liquidity risks. Although Corzine firmly believed that the existence of the EFSF mitigated default risk, he did not develop a strategy for managing the liquidity risks that would result if a credit downgrade prompted margin demands from counterparties. As Corzine built the company's European bond portfolio, counterparty margin demands became a major draw on MF Global's cash reserves, further exacerbating the company's liquidity strain.

These risks were compounded by the atmosphere that Corzine created at MF Global, in which no one could challenge his decisions. He hired his former gubernatorial chief of staff, Bradley Abelow, to serve as the company's COO. When Michael Roseman, the company's CRO, disagreed with Corzine about the size of the company's European bond portfolio, Corzine directed Roseman to report to Abelow rather than to MF Global's board of directors. This change effectively sidelined the most senior individual charged with monitoring the company's risks and deprived the board of an independent assessment of the risks that Corzine's European RTM trades posed to MF Global, its shareholders, and its customers. Additionally, by acting as the de facto chief trader for the company, Corzine insulated his trading activities from the company's normal risk management review process. He negotiated the size of the company's European bond portfolio solely with MF Global's board of directors, which he chaired.

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[459] John Gapper and Izabella Kaminska, *Downfall of MF Global*, FIN. TIMES, Nov. 4, 2011 (http://www.ft.com/intl/cms/s/0/2882d766-06fb-11e1-90de-00144feabdc0.html#axzz290FsXI68) (last visited Oct. 24, 2012).

Consequently, Corzine quickly built the company's European bond portfolio well in excess of prudent limits without effective resistance.

Rather than hold the European bonds on MF Global's books, which could expose the company to earnings volatility, Corzine chose to use these bonds as collateral in European RTM trades, permitting the company to book quick profits and "derecognize" the bonds from its balance sheet. As a result, MF Global did not initially disclose the full extent of its holdings in discussions with FINRA or in its public SEC filings, which meant that regulators and the investing public were not aware of all of the risks facing the company. By October 2011, MF Global had accumulated considerable exposure to European debt. The company's net European RTM portfolio was $6.3 billion, which amounted to 14 percent of MF Global's total assets and was orders of magnitude greater than the relative exposure of its larger competitors. The revelation of the surprising size of the company's portfolio, coupled with poor earnings news, prompted the credit rating agencies to downgrade the company's rating to junk status and set off a "run on the bank" by MF Global's investors, customers, counterparties, creating extraordinary demands upon the company's capital and liquidity reserves.

As MF Global's chief executive, Corzine was responsible for ensuring that the company maintained integrated systems and controls for managing the company's liquidity and protecting customer funds. However, under Corzine's tenure, the company's cash management, liquidity monitoring, and regulatory compliance functions remained fragmented among several of the company's departments. MF Global lacked any formal liquidity management framework, and the company could not fully assess and anticipate its liquidity needs. Under Corzine's leadership, the company failed to address concerns raised in an internal audit suggesting that MF Global's liquidity tracking and forecasting capabilities lagged behind the firm's evolving

business needs. Consequently, MF Global was unable to coordinate its activities during the liquidity crisis in its final days of operation. As the company struggled to find additional liquidity, company employees identified excess company funds held in customer accounts. However, because they did not have an accurate accounting of the amount of customer funds the company held, they withdrew customer funds as well as company funds. Prosecutors and MF Global's regulators will determine whether the company or its employees violated laws or regulations when these withdrawals were made. However, the responsibility for failing to maintain the systems and controls necessary to protect customer funds rests with Corzine. This failure represented a dereliction of his duty as MF Global's Chairman and CEO.

Recommendation:

The futures market cannot function unless customers are confident that FCMs will safeguard their funds. To restore investor confidence in the futures markets and help ensure that an FCM does not misuse customer funds in the future, the Subcommittee recommends that Congress consider enacting legislation that imposes civil liability on the officers and directors that sign a FCM's financial statements or authorize specific transfers from customer segregated accounts for regulatory shortfalls of segregated customer funds.

The SEC and the CFTC Failed to Share Critical Information about MF Global with One Another, Leaving Each Regulator with an Incomplete Understanding of the Company's Financial Health.

Following MF Global's collapse, the Subcommittee requested that the SEC and the CFTC produce all documents relating to each agency's regulatory oversight of MF Global during the twenty months leading up to its bankruptcy. These documents show no record of meaningful communication between the regulators regarding MF Global before the company's final week of

business, even though MFGI was registered with both agencies. The SEC's and the CFTC's failure to coordinate regulatory oversight of the company meant that the agencies missed several opportunities to share critical information with one another.

The SEC did not include the CFTC or the commodities SROs in the meeting it held with MF Global in June 2011 to examine the company's global operations and subsidiaries. That meeting, prompted by MFGI's continued losses and change in business strategy, would have been relevant to the CFTC's oversight of the company's FCM business.[460] Additionally, the SEC did not include the CFTC in its discussions with FINRA about the capital charge imposed on MF Global that resulted from its failure to take regulatory haircuts on the value of its European sovereign bonds, even though the decision to impose a capital charge would affect the regulatory capital the company would be required to maintain under both SEC and CFTC rules.[461] The CFTC, for its part, did not inform the SEC that MFGI was using the Alternative Method to calculate its obligations to its commodities customers trading on foreign exchanges, and that as a result the company could use the "excess margin funds" in secured customer accounts as a source of liquidity for its broker-dealer operations. Staff at the SEC's Division of Trading and Markets was surprised to learn MF Global was using the Alternative Method.[462] In their view, the Alternative Method allowed MF Global to "us[e] the FCM as an ATM."[463]

[460] E-mail from Kari Jin, Broker Dealer Risk Office, SEC, to Bob Larson, CBOE, Jeffrey Fortune, FINRA (June 7, 2011, 10:57 a.m.); In an email to FINRA personnel about the June 14, 2011 17-H meeting, SEC personnel stated that "[t]he SEC has concerns with MF Global." E-mail from Melanie Chan, SEC, to Jeffrey Fortune, FINRA (June 14, 2011, 12:25 p.m.).

[461] A CFTC senior staffer informed the O&I Subcommittee that, in hindsight, he wished that FINRA and the SEC had discussed the capital charge with the CFTC sooner. Had they done so, the staffer stated that the CFTC would have learned why FINRA was worried about the valuation of the European bonds for regulatory capital purposes, would have learned more about the nature of RTMs, and would have known in advance that MFGI was going to restate its capital. The staffer stated that he would like to know when a company enters into highly risky proprietary trades, even if it executes them through its securities broker-dealer. Interview with CFTC, *supra* note 117.

[462] June 2012 Interview with SEC, *supra* note 308.

[463] *Id.*

Even when the SEC and the CFTC finally began communicating with one another during MF Global's last week of operations, the agencies often worked at cross-purposes.[464] When MF Global reported that it had set aside $220 million above the amount it was required to hold for its broker-dealer customers, the SEC instructed the company not to transfer any of these funds without prior approval. Nonetheless, the CFTC later instructed the company to transfer the funds to the FCM side of its business. When informed of the transfer, SEC Chairman Mary Schapiro stated that the transfer was "unacceptable" and that the CFTC should not have ordered the transfer without telling the SEC.[465]

Had the SEC and the CFTC coordinated their supervision of MFGI and had they shared critical information about MF Global, they might have gained a more complete understanding of the company's deteriorating financial health, and they might taken action to better protect the company's customers and investors before it collapsed.

Recommendation:

When Congress established the CFTC in 1974, the CFTC and the SEC each had a clearly delineated jurisdiction over distinct markets.[466] But as financial markets evolved and financial products were developed that had attributes of both futures and securities, the jurisdictional dividing line between the CFTC and the SEC began to erode.[467] As a result, market participants found themselves subject to the regulatory authority of both the SEC and the CFTC.[468]

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[464] In an Oct. 30, 2011, email exchange between SEC's Director of the Division of Trading and Markets, Robert Cook, and SEC Chairman Mary Schapiro, the two acknowledged that there were three conference calls between securities and commodities regulators scheduled for 10 a.m. Chairman Schapiro commented, "Ahhhh, coordination in action!" To which Cook responded, "If we were really coordinated, we wouldn't have 3 calls at 10am!!" Chairman Schapiro responded, "Exactly!!" E-mail from Mary L. Schapiro, Chairman, SEC, to Robert W. Cook, Dir. of the Div. of Trading and Markets, SEC (Oct. 30, 2011, 09:54 a.m.).
[465] Schapiro E-mail, *supra* note 440.
[466] *A Joint Report of the SEC and the CFTC on Harmonization of Regulation*, at 15 (Oct. 16, 2009) (http://www.cftc.gov/ucm/groups/public/@otherif/documents/ifdocs/opacftc-secfinaljointreport101.pdf).
[467] *Id.*
[468] *Id.* at 16.

Exchanges that list and trade securities futures are subject to the jurisdiction of both regulators, as are financial intermediaries, like MF Global, that serve investors who trade both securities and futures.[469]

As financial products, markets, and market participants have converged, the SEC's and the CFTC's regulatory jurisdictions have increasingly overlapped. In response to this convergence, the regulators have pledged to work together in various areas. In 2004, the SEC and the CFTC signed a memorandum of understanding (MOU) under which they agreed to share information regarding securities futures regulated by both agencies.[470] The regulators signed another MOU in 2008 intended to create a formal structure for improved coordination and communication between the two agencies.[471] That MOU expressly directed the regulators to inform each other in advance of issues that might impact each others' jurisdiction, including supervisory developments and decisions, material events that may have a significant impact on the operations or activities of an entity or market, and enforcement actions, investigations, or sanctions.[472] A SEC press release touted the agreement as creating "a permanent regulatory liaison between the agencies" and establishing "a framework that will facilitate discussions and coordination regarding issues in…areas of common regulatory interest between the two agencies, such as…the oversight of firms registered with both agencies."[473] In 2009, the SEC and the

[469] *Id.*
[470] Memorandum of Understanding Between the SEC and the CFTC Regarding Oversight of Security Futures Product Trading and Sharing of Security Futures Product Information (Mar. 17, 2004) (http://www.cftc.gov/ucm/groups/public/@internationalaffairs/documents/file/moubetweencftcandsec031704.pdf) (last visited Oct. 17, 2012).
[471] Memorandum of Understanding Between the SEC and the CFTC Regarding Coordination in Areas of Common Regulatory Interest (Mar. 11, 2008) (http://www.sec.gov/news/press/2008/2008-40_mou.pdf) (last visited Oct. 17, 2012).
[472] *Id.* at 3.
[473] Press Release, SEC, SEC, CFTC Sign Agreement to Enhance Coordination, Facilitate Review of New Derivative Products (Mar. 11, 2008) (http://www.sec.gov/news/press/2008/2008-40.htm) (last visited Oct. 17, 2012).

CFTC met to discuss regulatory harmonization and later released a joint report recommending the creation of joint agency task forces on enforcement and information technology.[474]

None of these efforts, however, resulted in meaningful cooperation between the SEC and the CFTC regarding MF Global. The apparent inability of these agencies to coordinate their regulatory oversight efforts or to share vital information with one another, coupled with the reality that futures products, markets and market participants have converged, compel the Subcommittee to recommend that Congress explore whether customers and investors would be better served if the SEC and the CFTC streamline their operations or merge into a single financial regulatory agency that would have oversight of capital markets as a whole.

MF Global was not Forthright with Regulators or the Public About the Degree of its Exposure to its European Bond Portfolio, nor was the Company Forthright About its Liquidity Condition.

When MF Global first entered into European RTM trades in September 2010, the company neither acknowledged the exposure it had to European sovereign debt when questioned by its regulators, nor did it clearly describe the size and nature of its portfolio to the public in the company's regulatory filings.

When FINRA contacted MF Global in September 2010 to determine whether the company had exposure to European sovereign debt, the company responded that it had no such exposure even though it had already acquired between $1.5 and $2 billion of bonds. FINRA believes the MF Global's response was "negligent" or "misleading."[475]

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[474] SEC and CFTC Joint meetings on Harmonization of Regulation (Sept. 2, 2009) http://www.sec.gov/rules/other/2009/34-60539.pdf; CFTC and SEC, A Joint Report of the SEC and the CFTC on Harmonization of Regulation (Oct. 16, 2009), at 14-15 http://www.cftc.gov/ucm/groups/public/@otherif/documents/ifdocs/opacftc-secfinaljointreport101.pdf

[475] Interview with FINRA, *supra* note 291.

MF Global did not mention the net value of its European RTM trades in its September 2010 10-Q filing, even though the company had acquired between $1.5 and $2 billion worth of bonds, or in its December 2010 10-Q, when its bond holdings reached $4.5 billion. MF Global did not provide a more complete discussion of its European RTM trades, their accounting, and their risks until it filed its FY 2011 10-K report in May 2011. That report, filed over six months after MF Global began amassing its European RTM portfolio, was the first public filing to state the aggregate notional value of the trades, which by then had grown to $6.3 billion. In contrast to previous filings, the May 2011 10-K also identified the European nations whose sovereign bonds collateralized the European RTM trades. Finally, MF Global's September 2011 amended 10-Q provided no information to investors beyond noting that FINRA had required the company to increase its required net capital for certain RTM transactions collateralized with European sovereign debt.[476]

Had MF Global been more forthright about the size of its European bond portfolio as it amassed those positions, MFGI's regulators could have protected investors by requiring MF Global to take a capital charge commensurate with the risk posed by its portfolio.[477] Investors also could have decided for themselves whether the company's investments were sound. MF

[476] Specifically, the amendment represented that MFGI could comply with its capital requirements as a result of the charge, but it did not state the value of the European bond holdings by which MFGI calculated "haircuts" under the capital rule. The size of the capital charge imposed upon the company was directly proportional to the value of its European bond holdings. The Sept. 1, 2011 10-Q/A amended MF Global's quarterly report for the period ended June 30, 2011. The original filing disclosed that the notional value of MFGI's net exposure to European sovereign debt at the end of June. In Aug. 2011, MFGI transferred European RTM trades in Italian sovereign debt with a notional value of $4.2 billion to a non-regulated affiliate, thus reducing haircut charges by approximately $120 million.

[477] *Id.* Additionally, SEC staff was surprised to learn that MF Global had entered into the European RTM trades without taking haircuts on the European bonds. They believed that the capital rule was "cut and dry" and that, at a minimum, MF Global's executives should have asked the SEC to confirm whether the company's interpretation of the net capital rule was correct when they began entering into the European positions. June 2012 Interview with SEC, *supra* note 308. By contrast, MF Global's executives believed that the trades would not impose a capital cost on the company, relying, among other things, on guidance that held that the SEC's net capital rule did not require firms to take haircuts on U.S. Treasuries underlying European RTM trades. *See infra* at 50.

Global's failure to be fully transparent about the size of its European bond portfolio denied regulators and the public the opportunity to inform themselves about the extent of MF Global's European RTM trades and to respond accordingly. As a result, the company's investors, customers and counterparties were stunned when the Wall Street Journal reported the size of the company's European bond portfolio in October 2011. The ensuing panic precipitated the company's rapid collapse.

In addition, certain public statements asserted by MF Global executives in the week leading up to the company's bankruptcy appeared to have painted a more optimistic picture of MF Global's financial condition than what may have been understood privately. On October 6, 2011, Steenkamp informed Corzine that one of MF Global's subsidiaries was again undergoing significant liquidity stress after having experienced a couple of "better days" in the first week of October.[478] In particular, Steenkamp characterized MFGI's liquidity as being in a state of "sustained stress," writing that its broker-dealer was "currently unable to fund itself," and that its need for cash injections from the FCM was becoming permanent because funds from other sources were insufficient to meet the broker-dealer's needs. Steenkamp also cautioned Corzine that the broker-dealer's liquidity demands were in part due to the margin required to cover MF Global's European RTM trades — which at the end of September totaled more than $400 million — and that it could be more challenging for MFGI to draw down its revolving credit line as a result of its liquidity condition.[479] Nineteen days later, on an October 25, 2011 earnings call, Steenkamp and Corzine discussed MF Global's overall financial condition for the fiscal quarter

[478] In his e-mail to Corzine, the O&I Subcomm. believes that Steenkamp referred to a liquidity condition that existed before Oct. 2011. *See* Steenkamp E-mail, *supra* note 286 ("There remains a significant stress on liquidity—this week, after a couple of better days since quarter-end [on Sept. 30, 2011], the stresses have *returned*") (emphasis added).

[479] *Id*. ("Of most concern, is the sustained levels of stress and the lack of signs this will reduce soon. It makes drawdowns of the revolver more challenging, as we cannot guarantee certainty of immediate repayment. The revolver is not meant as a source of permanent liquidity").

ended September 30. Steenkamp described the ways in which MF Global had "improved [its] capital and liquidity positions" that quarter and expressed his optimism that despite "uncertain and volatile times, we feel good about [MF Global's] capital structure and liquidity positions."[480] Corzine backed Steenkamp's claim by stating that MF Global's actions had put the firm in a "much, much stronger liquidity position" as of September 30.[481] As a result of these public statements, investors were not aware of MFGI's liquidity issues and could not asses their impact on MF Global's overall condition.

Recommendations:

Federal securities laws and SEC rules are intended to protect investors by ensuring that public companies disclose sufficient information for individuals to make informed investment decisions. The Subcommittee recommends that the SEC investigate whether MF Global violated these laws or rules in connection with its disclosures about the European RTM trades and the firm's overall financial health.

MF Global's ability to amass more than $6.3 billion in European sovereign debt without fully disclosing the size and nature of its European RTM portfolio raises concerns about the sufficiency of off-balance sheet reporting requirements under GAAP and SEC rules. In May, FINRA proposed a rule requiring member companies to disclose the gross contract value of European RTM trades that are derecognized from their balance sheets in a supplementary schedule for quarterly FOCUS reports.[482] FASB has also tentatively voted to amend its accounting guidance to require RTM transactions to be accounted for as secured borrowings

[480] MF Global Holdings Ltd., F2Q 2012 Results (Qtr End Sept. 30, 2011) Earnings Call Transcript (Oct. 25, 2011).
[481] *Id*.
[482] Supplemental FOCUS Information: FINRA Requests Comment on Proposed Supplementary Schedule for Derivatives and Other Off-Balance Sheet Items, FINRA Regulatory Notice 12-23.

rather than sales, which would result in transferred financial assets being treated as if the assets were used as collateral for borrowed funds, instead of recording the assets as being sold.[483] The Subcommittee understands that FASB intends to release an exposure draft of its proposal for public comment by the end of this year. The Subcommittee views these rules as a positive development and recommends that the SEC consider enhancing its own disclosure and accounting rules to better ensure that investors have timely information about off-balance sheet transactions, including RTM trades.

Moody's and S&P Failed to Identify the Biggest Risk to MF Global's Financial Health.

While Moody's and S&P acknowledged that MF Global's transformation into an investment bank would increase the company's risk profile as it took on greater proprietary trading positions, the credit rating agencies did not sufficiently review MF Global's public filings to identify these risks when they did emerge. Beginning in May 2011, MF Global disclosed in its fiscal year 2011 10-K, and in a subsequent quarterly filing, that it had over $6 billion in net exposure through European RTM trades; that it bore default risk on the bonds that collateralized them; and that it could be subject to margin calls until the trades concluded. MF Global's September 2011 amended 10-Q also cited FINRA's concerns about the company's exposure to European sovereign debt.

Despite the information that was available to them for a period of five months, Moody's and S&P did not factor MF Global's European sovereign debt exposure into its public credit assessments until one week before MF Global filed for bankruptcy. It was not until October 24, 2011, that Moody's identified MF Global's "outsized … exposure to European sovereign debt"

[483] Summary of Board Decisions, FASB (Oct. 3, 2012).

as a reason for a ratings downgrade.[484] S&P similarly placed MF Global on "credit watch negative" on October 26, 2011, partly because MF Global's European RTM trade exposure was "very high compared to the company's loss absorbing base."

Moody's and S&P also did not understand the nature of MF Global's European sovereign exposure. Both firms believed that the European RTM trades were client-driven transactions, and that MF Global hedged the risks of these transactions. But, their understanding was inconsistent with MF Global's public filings, which stated that the company maintained exposure to the underlying sovereign issuer and that mark to market movements associated with the European RTM trades could cause volatility in MF Global's financial results. MF Global's CFO also stated in a May 2011 earnings call that MF Global entered the European RTM trades because it identified principal trading opportunities.[485]

In the case of MF Global, Moody's and S&P's failures are notable because they suggest an absence of due diligence. Both firms received substantive information about MF Global's financial health and discounted its significance or altogether failed to identify or understand it. Additionally, documents reviewed by the Subcommittee demonstrate that neither Moody's nor S&P probed MF Global's European exposure until eleven days prior to the firm's bankruptcy. As a result, MF Global's credit ratings were not based on a complete examination of all relevant information that affected the company's long-term health.

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[484] Moody's Jan. 17, 2012 letter, *supra* note 80, at 12.

[485] MF Global Ltd. F4Q12 (Qtr End 03/31/11) Earnings Call Transcript (May 19, 2011). Though MF Global defined principal trading to include both proprietary trading as well as trading that facilitated client business, Steenkamp suggested the European RTM trades were proprietary positions when he described how the firm had reduced its "matched repo" book while entering into more European RTM trades, because the RTMs yielded greater revenues. The "matched repo book" referred to market making that facilitated client trades. Also, for the first quarter of FY12 the European sovereign positions accounted for about 12% of MF Global's revenues; another indication, by virtue of its relative size, that the trades were proprietary in nature. MF Global Ltd. F2Q12 (Qtr End 09/30/12) Earnings Call Transcript (Oct. 25, 2011).

Recommendation:

Given the significant and market-wide impact of credit ratings, investors expect Moody's and S&P to perform a careful and searching inquiry into the companies they rate. Their failure to do so in the case of MF Global raises questions about the role that credit rating agencies should play in financial markets.

Whether it is faulty ratings on Worldcom, Enron, structured financial products, or MF Global, the failures of rating agencies to exercise due diligence have significantly affected markets. Given the credit rating industry's concentration – Moody's, S&P, and Fitch account for 98% of all ratings – the market impact of inaccurate ratings is magnified.[486]

In 2010, the House Committee on Financial Services (Committee) drafted reforms enacted in Section 939A of The Dodd-Frank Wall Street Reform and Consumer Protection Act (P.L 111-203) to reduce the reliance on the Nationally Recognized Statistical Rating Organizations (NRSROs). Section 939A received overwhelming bi-partisan support and was an important first step in the reform process. As such, the Committee must continue to hold regulatory agencies accountable for meeting the statutory objectives and deadlines established by Section 939A. The Subcommittee recommends that the Committee consider whether other legislative alternatives to promote greater competition in the credit rating industry are warranted.

The opinions and ratings that Moody's and S&P issued for MF Global exemplify a familiar pattern the three dominant rating agencies follow, in which ratings are "good" until a sudden event results in a precipitous downgrade that leaves investors and creditors stunned and

[486] Gary Shorter and Michael V. Seitzinger, Cong.Research Serv., Report R40613, Credit Rating Agencies and Their Regulation 1 (2010). http://www.crs.gov/Products//r/pdf/R40613.pdf (last visited Oct. 9, 2012).

scrambling. The Subcommittee believes that some form of periodic review could instill a greater level of scrutiny and diligence in the ratings process and give the investing public more confidence that the ratings they receive are current. To address the problems raised by sudden downgrades, the Subcommittee recommends that the Committee review whether the SEC should require each NRSRO to establish and enforce written policies and procedures reasonably designed to provide for periodic monitoring of credit ratings and periodic communications to the market about the NRSRO's monitoring practices.

MF Global's Use of the "Alternative Method" Allowed the Company to use Some Customer Funds as a Source of Capital for the Company's Day-to-Day Operations, Which Subjected Customers to the Risk that MF Global Would Not be Able to Return Those Funds to Customer Accounts Upon the Company's Insolvency.

The "Alternative Method" of calculating the amount of funds to set aside in secured accounts for customers trading on foreign exchanges allowed MF Global's executives to use certain customer funds to meet the company's liquidity needs. MF Global's executives determined that the Alternative Method did not require the company to set aside excess margin funds in secured accounts and as a result, MF Global used these funds for its own purposes. MF Global therefore subjected customers who traded on foreign exchanges to the risk that during a period of financial distress, the company would not be able to set aside funds in secured accounts equal to what MF Global owed them.[487] The risk was evident to commodities regulators,

[487] The risk faced by MF Global's foreign secured customers was relatively low in the months leading up to the company's failure because MF Global usually maintained a positive "Firm Invested in Excess," meaning that the company deposited funds in secured and segregated accounts (which were for customers' domestic trading) that exceeded, in the aggregate, the company's liabilities to customers. On certain days in the last week of Oct. 2011, however, the risk that customers faced became greater. Internal statements prepared by MF Global reflected a negative Firm Invested in Excess, which indicated that the company's liabilities to its customers were greater than the aggregate assets on deposit in secured and segregated accounts.

however, and in the last week of October 2011, staff from the CFTC and the CME Group actively encouraged MF Global to move funds into its secured accounts.[488]

In addition, MFGI's use of the Alternative Method contributed to the $900 million shortfall in the company's *segregated* accounts. The substantial excess funds in secured accounts under the Alternative Method made customer accounts a more attractive source of liquidity for the company's day-to-day activities. In MFGI's hectic final days, the company repeatedly transferred funds into and out of segregated accounts, amplifying the risk that it would miscalculate account balances for regulatory purposes. The Alternative Method, combined with the risk that such a miscalculation would occur, increased the chance that transfers made by MFGI would result in a deficiency of customer funds.

Recommendation:

By permitting FCMs to exclude a customer's excess margin funds from the amount that must be set aside in secured accounts, the Alternative Method is inconsistent with the Commodity Exchange Act's "bedrock" customer protection principle, which "ensure[s] that property entrusted by customers to their brokers will not be subject to the risks of the broker's business."[489] Staff from the CFTC and the CME Group recognized that MF Global's use of the Alternative Method posed precisely this risk and, in the company's final days, devoted significant resources to ensure that the company set aside more funds in the secured accounts.

On October 23, 2012, the CFTC announced that it would be proposing new rules to enhance customer protections by, among other things, amending Part 30 of its regulations to no

[488] Despite the risks faced by MF Global's secured customers, and the regulators' concerns, by the time the company filed for bankruptcy, funds in the accounts exceeded MF Global's liabilities to foreign-trading customers by approximately $4 million.

[489] *In re Stotler & Co.*, 144 B.R. 385, 387 (N.D. Ill. 1992) (quoting S. Rep. No. 989, 95th Cong. 2d Sess. (1977)).

longer permit FCMs to use the Alternative Method.[490] Instead, FCMs would be required to hold sufficient funds in secured accounts to meet their total obligations to customers computed under the net liquidation method.[491] This rule change would echo actions already taken by the NFA earlier this year to strengthen the protection of customer funds held by its members.[492] The Subcommittee welcomes the CFTC's announcement of proposed rules and will follow their development with great interest.

The New York Fed Should Have Exercised Greater Caution in Determining Whether to Designate MF Global as a Primary Dealer, Given the Company's Prior Risk Management Failures, Chronic Net Losses, and Evolving Business Strategy.

Under its primary dealer program, the New York Fed grants financial companies the privilege of acting as counterparties to open market operations executed by the New York Fed. These open market operations are undertaken in furtherance of U.S. monetary policy pursuant under the direction of the Federal Open Market Committee. Over time, market watchers have come to regard a primary dealer designation as a "Good Housekeeping seal of approval," enhancing a company's standing in the marketplace.[493]

The New York Fed has attempted to eliminate this market perception by stating in its primary dealer application that the designation neither constitutes an endorsement of the company nor replaces prudent counterparty risk management and due diligence. Written

[490] Press Release, CFTC, CFTC Proposes New Regulations and to Amend Existing Regulations to Enhance Protections for Customers and Customer Funds Held by FCMs and Derivatives Clearing Organizations (Oct. 23, 2012).
[491] *Id.*
[492] Press Release, CFTC, CFTC Approves New Financial Rules Submitted by the NFA to Strengthen the Protection of Customer Funds Held by FCMs, CFTC (July 13, 2012); Letters from Thomas W. Sexton, Sr. V.P. and Gen. Counsel, NFA, to David A. Stawick, Office of the Secretariat, CFTC (May 29, 2012 and Aug. 21, 2012) .
[493] Dec. 15, 2011 Hearing, *supra* note 50, at 94. The NYFRB has used the term the "Good Housekeeping Seal of Approval" as a description that industry sees primary dealer status as an endorsement by the NYFRB.

testimony and letters from the New York Fed's General Counsel echo the same warning. Nonetheless, despite its admonitions to the contrary cautioning otherwise, the New York Fed is aware that the financial services industry views primary dealer designation as conferring prestige on firms that are so designated. The New York Fed's General Counsel conceded that the market may view a primary dealer designation as a sign of a company's capabilities and that the perception may encourage companies to apply to the program. A former Executive Vice President of the New York Fed commented that the New York Fed's practice of pre-approving counterparties as part of the primary dealer program results in an "irreducible minimum Good Housekeeping Seal of Approval."[494]

During the course of MFGI's application to be designated a primary dealer, the New York Fed was made aware of several issues regarding the questionable financial health and stability of MF Global. First, the CFTC informed the New York Fed of four separate instances of risk management failures by MF Global. As a result of these compliance failures, the CFTC fined MF Global $10 million and required it to strengthen its risk monitoring procedures and to undertake an independent review and assessment by a risk management and regulatory compliance consulting firm. Second, MF Global reported net losses that doubled in size from fiscal years 2008 to 2010. Finally, MF Global's new CEO, Jon Corzine, announced that he would embark on an aggressive and risky business strategy to turn the company into a full-service global investment bank within three to five years.

The New York Fed was also aware that MF Global's leadership counted on MFGI being designated a primary dealer to carry out its business strategy, even though the New York Fed cautioned MF Global not to do so. MF Global's former CEO Bernie Dan and then Corzine both

[494] Telephone Interview by O&I Subcomm. staff with Peter Fisher, former Exec. V.P. of NYFRB, in Wash., D.C. (July 23, 2012).

violated the New York Fed's explicit warning by speaking openly with the press about the company's desire for MFGI to become a primary dealer. MF Global's General Counsel informed New York Fed employees that the company had spent resources and hired individuals specifically for the purpose of MFGI becoming a primary dealer. The actions of MF Global's leadership and the concerns about the company's financial health led one New York Fed employee to suggest that his colleagues focus on "well known and respected firms" for primary dealer designation, rather than "spending so much time with MF Global, a firm that clearly brings a high degree of risk to the New York Fed."[495]

MF Global's risk management failures, chronic net losses, and untested business strategy, combined with the New York Fed's internal concerns that MF Global posed reputational risks, should have given the New York Fed pause before conferring primary dealer status on MFGI. Even though the subsidiary met the basic requirements to become a primary dealer, the New York Fed should have, at a minimum, placed MFGI's application on hold until MF Global's new business strategy had been successfully implemented.

Recommendations:

The New York Fed is aware that the financial services industry views a primary dealer designation as carrying the "Good Housekeeping Seal of Approval" and that the New York Fed's disclaimers have not been effective in removing that perception. As a consequence, and in contravention of the New York Fed's directives, applicant companies may incorporate becoming a primary dealer into their business strategy or tout their application to the media. In order to further discourage companies from utilizing a primary dealer designation beyond its intended purpose, the Subcommittee recommends that the New York Fed examine strengthening its application guidelines to expressly forbid companies from speaking to publicly about their

[495] Email from Krevolin, NYFRB, to Wolgemuth, NYFRB (Apr. 6, 2009, 07:26 p.m.)

application status during the pendency of the application unless required for regulatory disclosure purposes. If an applicant company ignores the disclosure prohibition, the New York Fed should consider instituting a cooling-off period, similar to the one-year delay for material regulatory actions.

The Subcommittee further recommends that the New York Fed consider re-examining its primary dealer selection process to provide for greater scrutiny of companies with questionable financial health, risk management histories, and ambitious business strategies. If a company has experienced multi-year losses, chronic regulatory failures, or is in the process of implementing a dramatic change in business strategy – red flags that were clearly present during MFGI's application – the New York Fed should consider prolonging the application process to better assess how these factors will affect the company's overall suitability as a counterparty.

Differences Between Foreign and U.S. Law Gave Rise to the Potential that MFGI Global Customers Trading on Foreign Exchanges Would Experience a "Shortfall" in Funds Owed to Them, Despite the Fact that Such Funds Were set Aside in Accounts Designated as Secured Accounts.

MFGI customers who traded abroad faced the risk that the funds set aside in secured accounts would not readily be available to satisfy their claims upon MFGI's bankruptcy and subsequent liquidation. Customers who traded foreign futures and options executed and cleared trades on foreign exchanges, which were beyond the jurisdiction of the U.S. authorities. MFGUK acted on behalf of MFGI when the latter's customers instructed MFGI to place a trade on a foreign exchange with which MFGUK maintained a trading relationship. To effectuate those trades, MFGI maintained a secured account with MFGUK, into which MFGI deposited funds to margin its customers' futures and options positions. The disposition of funds in

MFGUK's account was subject to British law when MFGUK entered into administration following the collapse of its U.S. affiliates and parent on October 31, 2011. In a mandatory disclosure made by MFGI to customers when they opened their accounts, the company had cautioned that funds margining foreign futures transactions "may not be provided the same protections as funds received to margin futures transactions on domestic exchanges."[496]

When MFGI collapsed, the assets in its secured accounts exceeded the company's liabilities to customers who traded abroad by approximately $4 million. Nonetheless, the trustee liquidating MFGI determined that there was a shortfall of $700 million in funds available to satisfy these customers' claims. This shortfall arose because MFGI placed a "significant percentage" of customer funds in a secured account at MFGUK; and MFGUK has disputed whether MFGI is entitled to these funds in preference to other creditors of MFGUK under British law. As a result, MFGUK will not return these funds to MFGI (for subsequent distribution to customers who traded on foreign exchanges) until this question is resolved in a trial scheduled to take place in the summer of 2013 in the United Kingdom. Because a substantial portion of customer funds were in MFGUK's secured account, as of June 2012, MFGI's trustee was able to make a limited distribution to foreign-trading customers equal to approximately ten percent of their claims.

Recommendation:

The Subcommittee recommends that the Committee on Agriculture consider whether to direct the CFTC to study whether it can better mitigate the risks that FCM customers face when customer funds are placed in secured accounts subject to the law of a foreign jurisdiction. In

[496] 17 C.F.R. §30.6; *see also* 17 C.F.R. §1.55 (prescribing text of disclosure statement).

conducting any such study, the CFTC should consider whether the rules that govern trading on foreign exchanges should be amended to establish protections comparable to those that govern domestic transactions. In particular, the CFTC should consider whether any potential rule change could impose costs on FCMs and their customers that would place foreign futures and options trading at a competitive disadvantage to similar products and services.