

Lessons from the MF Global Collapse*

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Lessons from the MF Global Collapse*

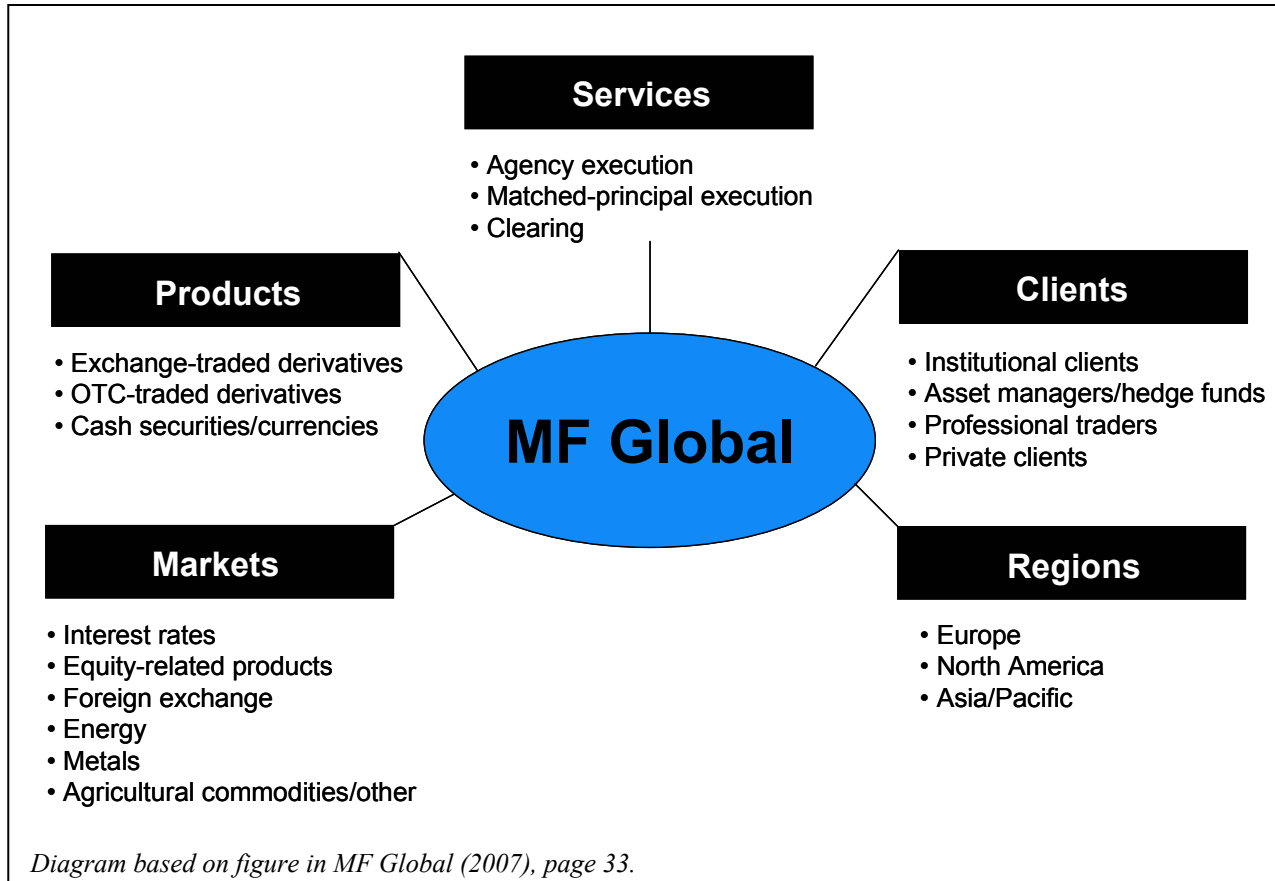
1. **Background on the Firm**
2. **Overall Narrative**
3. **Lessons from Collapse (Thus Far)**



* *The outline of facts in this section is based on publicly available information as of 4/19/12.*

Source: Updated from Till (2012).

1. Background on the Firm



2. Overall Narrative

- Prior to the firm's spin-out from its parent company in 2007, MF Global had been a “dull normal” business, as a futures broker.
- During the spin-out of MF Global, the parent company burdened MF Global with (arguably) an enormous short-term debt load*, relative to the firm's profitability.
- The spin-out occurred just before the onset of the Global Financial Crisis, making it uncertain throughout 2008 how the firm would be able to refinance its short-term debt.

* Sources: *Hedge Fund Daily* (2007) and *MF Global* (2007).

2. Overall Narrative

- The firm's business model became in jeopardy during the compression of yields available in fixed-income investments.
- The firm had strongly relied on income from the investment of customer collateral for its profitability.
- A Futures Commission Merchant (FCM) is allowed to credit back to customers only a fraction of the income that the FCM earns on customer collateral.

2. Overall Narrative

- In 2010, the firm hired a CEO, who had a previously successful career in both large-scale proprietary trading and in high-level U.S. politics.
- In Congressional testimony in December 2011, this CEO admitted that he “had little expertise or experience in ... [the] operational aspects of” MF Global.

2. Overall Narrative

- Various Commodity Futures Trading Commission (CFTC) regulations had allowed a lot of flexibility in how FCMs were allowed to invest customer funds.
- An FCM was allowed to borrow from customer funds using “internal repurchase agreements.”
- [After MF Global’s collapse, in December 2011 “the CFTC banned ... in-house repurchase agreements ...”, according to Bunge and Ackerman (2011).]
- According to Congressional testimony by MF Global Inc.’s Chief Financial Officer, “inter-departmental lending [between the FCM and the broker-dealer unit] on an intraday basis was not unusual,” as noted in Serwinski (2012).

2. Overall Narrative

- In addition, MF Global customer account documents allowed the firm to “rehypothecate” customer funds whereby the broker re-uses collateral posted by clients to back the *broker’s own trades* and borrowings.

Consent to Loan or Pledge

“You hereby grant us the right, in accordance with Applicable Law, to borrow, pledge, repledge, transfer, hypothecate, rehypothecate, loan, or invest any of the [customer’s] [c]ollateral, including, without limitation, utilizing the [c]ollateral to purchase or sell securities pursuant to repurchase agreements or reverse repurchase agreements with any party, in each case without notice to you, and we shall have no obligation to retain a like amount of similar [c]ollateral in our possession and control.”

2. Overall Narrative

- Therefore, MF Global would have been technically permitted to use customer funds (as the original source of capital) to collateralize a large-scale, leveraged, proprietary trade on five European bond markets,* which the CEO had devised in an apparent bid to assure the firm's profitability.
- Interestingly, as of October 13th, 2011, the firm apparently did not have a “clear strategy and plan” for hedging or unwinding this financed portfolio in case of a “downgrade to sub-investment grade by at least 2 rating agencies,” according to MF Global (2011b), Slides 1 and 11.
- Patterson (2012) referred to MF Global (2011b) as the firm's “break-the-glass” document.

* Source: Henning (2011).

2. Overall Narrative

- An added wrinkle to the story is that when an FCM has a U.K. subsidiary, that FCM can obtain financing for proprietary trading more readily than in the U.S. since in the U.K., there is no statutory limit to the amount of leverage that one can obtain against borrowed collateral through rehypothecation.
- MF Global's European bond trade was executed through its U.K. subsidiary.*

2. Overall Narrative

- [Somewhat astonishingly, perhaps, MF Global’s “break-the-glass” document includes as one of its bullet points:
 - “Consider [what] ... requirements the FSA [U.K. Financial Services Authority] can impose[,] and develop [a] contingency plan to approach Federal Reserve Bank (NY and Washington) and possibly [U.S.] Treasury for support if FSA requests might threaten firm.”]

2. Overall Narrative

- The firm's leveraged European bond bet *per se* did not cause MF Global's collapse.
- The bet had been well disclosed in publicly available MF Global documents*, and the performance of short-maturity European bonds up until the firm's collapse had *not* been disastrous.
- [That said, even though the bet was disclosed in May 2011 filings, another wrinkle in the story is that the particular transaction structure that MF Global used for its bond bet was recognized in its accounting statements as a “sale” rather than as a “secured borrowing,”** which is another astonishing aspect of this narrative.
- One might consider this fact astonishing since MF Global retained all credit risk with this “sale.”]

* Sources: Tavakoli (2011) and MF Global (2011a).

** Source: Cospes (2012).

2. Overall Narrative

- At the end of October 2011, in rapid succession, the firm experienced a credit downgrade and announced worst-than-expected earnings, leading investors, clients, and creditors to doubt the sustainability of the firm's business model.

2. Overall Narrative

- During the last week of October 2011, the firm rapidly liquidated some of its European bond bet; attempted to meet additional margin calls that resulted from a ratings downgrade; and attempted to meet customer redemptions as clients left the firm *en masse*.
- Some customers, who had requested wire transfers from their accounts, were instead mailed checks, which then bounced when the customers tried to cash these checks, according to Goldstein (2011).
- [Slide 11 of MF Global (2011b) includes the following curious questions in their contingency planning: “How quickly do we want to send cash back to clients[:] what is the message if we do not send immediately[?]”]

2. Overall Narrative

- As the last week of October progressed, a key complication was that MF Global's clearing bank was slow in clearing and settling both the firm's bond trades and its commercial-paper sales.
- For the latter sales, "it remains unclear exactly what cash from the sale was ultimately routed to MF Global," reported Mollenkamp *et al.* (2012).

2. Overall Narrative

- Perhaps another complication was that during the last week of October, MF Global Inc.'s CFO had been out of the office.
- She had resigned from MF Global in June 2011, and had stayed on at the firm to find and train a replacement.
- Her last day at the firm had been scheduled to be Tuesday, November 1st. She was scheduled to come back into the office on Monday, October 31st.
- The operating company CFO proactively came back into the office a day early on Sunday night, October 30th.

2. Overall Narrative

- One might consider it difficult-to-explain why the operating company CFO was not called back into the office by her direct reports during the last week of October, as the firm became in financial distress.
- This is noteworthy since the firm’s “break-the-glass” scenario analysis “had been initiated in early 2011,” according to Patterson (2012.)
- This document* notes that the operational response in case of credit ratings downgrades should include:
 - “all support functions maintaining ‘all hands on deck’ with all relevant team members for the foreseeable future.”

* Source: MF Global (2011b), Slide 12.

2. Overall Narrative

- MF Global held some of its own funds and customer funds in a common bank accounts.
- The firm kept track of how much of the funds were proprietary versus how much belonged to customers through a spreadsheet.
- As the week progressed, the firm's official books and records were eventually not updated.

2. Overall Narrative

- On Friday, October 28th, the firm's main clearing bank wanted written assurance that “all [wire] transfers made by MF Global – past and future – complied with, and would comply with, applicable [customer fund] segregation rules,” noted Ferber (2012).
- As it turned out, no officer of MF Global, either in the holding company or the operating subsidiary, would provide such written assurance, even when the language of this “compliance certificate” was narrowed.
- Interestingly, the clearing bank's deputy general counsel testified that on Sunday, October 30th, the bank's “belief was that, given all that was happening at MF Global that day, they simply had numerous pressing matters to attend to that prevented them from turning their attention back to our letter,” as stated in Genova (2012).

2. Overall Narrative

- On Sunday, October 30th, the holding company planned “to conduct a series of auctions beginning at 7:00 a.m. for most of the firm’s remaining balance sheet of securities, including the European sovereign debt, with the goal to convert the firm’s balance sheet almost entirely to cash.”

2. Overall Narrative

- But by the early morning of Monday, October 31st, regulators were losing confidence in the firm when it was unable to reconcile its books and satisfactorily explain a significant shortfall that had been discovered in the firm's customer segregated accounts.
- This “shortfall was without precedent in the history of the futures industry,” according to a U.S. House of Representatives (2012) memorandum.
- At about 2 a.m., “MF Global informed the CFTC and CME that customer money had been transferred out of segregation to firm accounts,” according to CME Group Executive Chairman Terry Duffy, as reported by Collins (2012a.)
- A potential deal for another firm to buy MF Global Inc. then collapsed, given the shortfall in customer segregated accounts.

2. Overall Narrative

- The MF Global Inc. CFO stated in her Congressional testimony that in the early morning hours of Monday, October 31st, “we were able to move some funds into the FCM’s segregated and secured accounts, [but that] a number of submitted transfers were not executed by the banks, and we were unable to move sufficient funds to make up for the shortfall,” as recounted in Serwinski (2012).
- According to a U.S. House of Representatives (2012) memorandum, the MF Global Inc. CFO “also requested a transfer of funds from MF Global’s U.K. subsidiary on Monday morning, but the U.K. financial regulator had frozen the subsidiary’s accounts.”

2. Overall Narrative

- The MF Global Holdings Ltd.’s General Counsel recalled in her Congressional testimony that “prior to filing the bankruptcy petition, the company waited, with the agreement of the regulators, until the Fedwire opened in the morning to see if house trades settled so that MF Global could use available cash and collateral to fill the gap in [customer] segregated funds.”

2. Overall Narrative

- “However, when the Fedwire opened at 8:30 a.m. on the morning of October 31, it became apparent that banks and others were not settling trades or moving money to MF Global accounts,” as noted in Ferber (2012).
- The MF Global Inc. CFO said that “[d]uring the morning of [Monday] October 31, I learned that MF Global had filed for bankruptcy. I was told we were under Securities Investor Protection Corporation (“SIPC”) protection sometime during the day on Monday. Eventually, I was informed by SIPC that the Firm could no longer engage in any further financial transactions,” as summarized in Serwinski (2012).

2. Overall Narrative

- Specifically, in the morning of Monday, October 31st, 2011, the holding company declared bankruptcy under Chapter 11 of the Bankruptcy Code; and the Broker-Dealer/Futures Commission Merchant (FCM) subsidiary was put into liquidation in a **Securities** Investors Protection Act (SIPA) proceeding.

2. Overall Narrative

- According to Sommers (2011), “The CFTC [had] supported getting MF Global into a bankruptcy proceeding as quickly as possible ...”
- [One assumes that this became the CFTC’s stance because of a loss of faith in the firm when satisfactory explanations of the customer segregated fund shortfall were not forthcoming.
- One might imagine that the following questions might have been uppermost in the mind of regulators during the morning of October 31st. Was the movement of funds from customer accounts due to unlawful transactions? Who authorized these transactions? Were the firm’s internal controls falling apart? How could the firm not readily explain what happened to many hundreds of millions of dollars in customer funds?
- One might assume that the same types of questions were of concern by the U.K. financial regulator as well.]

2. Overall Narrative

- The SIPA process did provide a ready solution to “getting MF Global into a bankruptcy proceeding as quickly as possible.”

2. Overall Narrative

- “Under SIPA, the Securities and Exchange Commission (SEC) has the authority to refer an entity registered as a broker-dealer (BD) (whether or not such entity is also registered as an FCM) to the Securities Investors Protection Corporation (SIPC) if there is reason to believe that the entity is in or is approaching financial difficulty.”
- “SIPC may initiate a liquidation proceeding to protect customers of an insolvent BD when certain statutory criteria are met.”
- “... MF Global consented to being placed into the SIPA liquidation proceeding.”

2. Overall Narrative

- “When a BD is also a registered FCM, as MF Global was, there is one dually-registered entity and the entire entity gets placed into liquidation.”
- “Because there is one entity, it is not possible to initiate a SIPA liquidation of the BD, and a separate bankruptcy proceeding for the FCM.”

2. Overall Narrative

- The legal procedures, though, which cover the liquidation of securities firms, can be interpreted such that they conflict with the legal procedures that were designed for the bankruptcy of futures firms. MF Global was regulated by the SEC *and* by the CFTC.
- That said, there is a credible body of law that futures customers should have priority over all other claimants.

2. Overall Narrative

- As noted, on October 31st, the SEC and CFTC “announced ‘that a SIPC-led bankruptcy proceeding would be the safest and most prudent course of action to protect customer assets.’”
- “This [decision] *baffled* futures industry participants who felt it would delay customers being made whole.”
- “... [F]utures regulators *in the past* had gone to court to fight for jurisdiction when an asset freeze would be adverse to futures industry customers.” [Italics added.]

2. Overall Narrative

- Futures customers of MF Global had been caught flat-footed by the MF Global bankruptcy. With the Refco and Lehman bankruptcies, the CFTC and futures exchanges had worked to move futures accounts and customer funds to other FCMs before the FCM was put into bankruptcy.
- [That said, one wrinkle with the Lehman bankruptcy was that the custodian bank holding Lehman customer funds did hold onto these funds for 10 days, according to FIA (2008), rather than immediately transfer funds to the new solvent FCM.
- On 4/4/12, the CFTC fined the custodian bank \$20 million for “unlawfully handling customer segregated funds,” as noted in CFTC (2012).]

2. Overall Narrative

- Like the Refco and Lehman bankruptcies, MF Global customers had assumed that their positions and funds would be moved by regulators and the exchanges to new FCM(s) before an MF Global Inc. bankruptcy was executed.
- This did not happen.
- Instead, starting on Monday, October 31st, 2011, MF Global customers' funds and futures positions were frozen on and off for days.

2. Overall Narrative

- Astonishingly, “[w]hen the MFG bankruptcy was filed[,] *nobody* appeared in court to represent the interests of customers, either to contest the filing under SIPA as opposed to [a filing that explicitly covered procedures for futures firms], or to oppose the claims of creditors whose interests were directly adverse to customers.” [Italics added.]

2. Overall Narrative

- Stepping into the vacuum, two Chicago futures traders quickly and proactively created a grassroots organization to represent the interests of futures customers in ongoing proceedings.
- This *ad hoc* group defended the “basic principles of [customer fund] segregation.”
- This grassroots organization is the Commodity Customer Coalition (CCC) and includes 8,000 customers of MF Global.
- The CCC’s main lawyer represented customers in court on a *pro bono* basis.

2. Overall Narrative

- The CCC:

“- objected to the Bankruptcy Trustee’s original plan to return 60% of customer funds ... [not until] July 2012, and instead, with the help of the CME, won a court ordered distribution ...” and

“- ... blocked an [initial] attempt by [a bank] ... to receive a superior priority over customer funds”.

- [The CCC also “authored many of the questions [later] used by Congress in the Financial Services and Senate Agriculture Committee hearings”.]

2. Overall Narrative

- Within days of the bankruptcy, the Securities Investor Protection Corporation (SIPC) trustee did work with the CME and the CFTC to move customer positions and some of the margin associated with these accounts to other FCMs.

2. Overall Narrative

- Depending on whether customers had futures positions in their accounts or were all-cash accounts, various customers at first received differing amounts of money during this process.
- A total of three transfers have thus far been made by the trustee.

2. Overall Narrative

- The SIPC trustee responsible for liquidating MF Global Inc. went through a “steep learning curve regarding futures operations,” according to Collins (2012a).
- In November 2011, the CME Group proactively expedited the process of distributions to customers by providing a guarantee eventually totaling \$550 million, backstopping the trustee (in case a court would later determine that the trustee had paid out more funds than he was entitled to do so.)

2. Overall Narrative

- Thus far and after a number of delays, U.S. futures customers have received 72% of their funds back.
- The last transfer was in January 2012.
- As of 3/15/12, the MF Global Inc. Trustee had proposed expanding payouts to 82% of customer property.
- In addition, two European banks offered to buy customer claims for 90 to 91% of face value.

2. Overall Narrative

- What explains the shortfall in customer segregated funds at MF Global?

2. Overall Narrative

- Collins (2012b) summarized a U.S. Congressional staff memorandum of March 23rd, 2012.
- Approximately \$900 million of the customer account deficiency can be traced to “three types of transactions:

[1] intra-day loans between MF Global’s FCM and its broker dealer;

[2] the funding of outgoing broker dealer client funds; and

[3] a \$175 million transfer to MF Global’s London office on October 28.”

- According to Steinberg and Lucchetti (2012), the assistant treasurer at MF Global Inc. has continued to work “for the bankruptcy trustee [in] trying to recover money for MF Global customers ...”

2. Overall Narrative

- Approximately \$700 million in customer funds are also at the center of a dispute between U.S. and U.K. bankruptcy administrators in terms of which client pool has legal claim to these funds.
- This dispute brings up the question of whether these particular funds were ultimately U.S. customer funds that were, in turn, used as collateral for MF Global's leveraged, proprietary European debt trade that was executed through MF Global U.K.

2. Overall Narrative

- According to Sants (2012), the bankruptcy trustee for MF Global Inc. submitted a claim of \$742 million against MF Global U.K. Limited (MFGUK).
- “MFGUK segregated around \$79 million of client money provided by MF Global Inc. in respect of U.S. clients.”
- *“However, the major element in the U.S. trustee’s additional claim is based on the U.S. trustee disputing the basis upon which certain U.S. client securities were transferred to MFGUK.”* [Italics added.]
- “The U.S. trustee asserts that there is a claim on the U.K. client pool in respect of such securities.”

2. Overall Narrative

STATUS OF [MF Global Inc.] TRUSTEE'S INVESTIGATION OF CHASE	
Date:	April 4, 2012
	The Trustee has conducted an investigation of the actions of JPMorgan Chase Bank, N.A. regarding JPMorgan's activities in connection with MF Global. JPMorgan has cooperated with the Trustee's investigation, which has included witness interviews and review of extensive documentation by the Trustee's professionals, including attorneys and forensic accountants from Ernst & Young. The Trustee and JPMorgan are presently engaged in substantive discussions regarding the resolution of claims.

UPDATE ON STATUS OF [MF Global Inc.] INVESTIGATION [by the Trustee]	
Date:	April 12, 2012
	Based on his investigation of conduct, allocation of responsibilities and reporting with respect to the segregated customer accounts, the Trustee believes that there are claims he may assert against certain responsible individuals at MFGI and Holdings (and Holdings itself) for , among other things, breach of fiduciary duties owed to both MFGI and its customers, and violations of the segregation requirements of the Commodity Exchange Act. The Trustee is committed to discussing and working cooperatively to the extent possible with representatives of customers, with the goal of recovering customer property for distribution in accordance with the established claims process in the MFGI liquidation.

2. Overall Narrative

- According to Gasparino and Patel (2012), “Federal law enforcement authorities investigating the implosion of MF Global say the likelihood of a criminal prosecution has grown ...”
- “... federal law enforcement authorities have held high-level discussions about granting immunity from prosecution to [the] former MF Global [Inc.] assistant treasurer ... in exchange for her cooperating in the probe.”

2. Overall Narrative

- The authoritative narrative on the MF Global collapse will have to wait until (1) the official investigations regarding this collapse have been concluded and documented, and (2) the priority of claims in the U.S. and U.K. bankruptcy proceedings is fully litigated.

2. Overall Narrative

- Regarding the situation for MF Global's U.S. customers, after a substantial delay, the trustee for the operating subsidiary, MF Global Inc., did recognize the primacy of customer segregated funds in a liquidation.
- But the judge overseeing MF Global's bankruptcy rejected a claim that segregated-account funds should have a first priority in the estate of MF Global Holdings Ltd., the parent company.
- The trustee of the holding company also does not view segregated accounts as having a first priority on the holding company's estate.

2. Overall Narrative

- [It is noteworthy that Chapter 11 of the U.S. Bankruptcy Code grants repo counterparties “super-advantages” in claims on a bankrupt company’s estate, according to Roe (2011).*]
- This “right to jump to the head of bankruptcy re-payment line” may become relevant in MF Global Holding Ltd.’s bankruptcy proceedings.]

* This article was pointed out at <http://www.mfgfacts.com>.

3. Lessons Thus Far

The lessons from the MF Global collapse thus far are as follows:

- [1] Futures customers can lose some or all of their collateral during the collapse of an FCM;
- [2] All futures customers should do their own due diligence on the credit worthiness of their FCM*;
- [3] Futures customers should familiarize themselves and be comfortable with how their funds are being invested by their FCM**;

* Roth (2012) stated that the National Futures Association has appointed a Special Committee for the Protection of Customer Funds. “The Special Committee’s initial focus has been on making it easier for small customers to do meaningful due diligence on an FCM before opening an account.”

** For example, one Chicago-based FCM announced in December 2011 that starting at that time, clients would be able to see how their customer segregated funds were invested on the FCM’s website, according to RCG – Customer Care (2011).

3. Lessons Thus Far

- [4] A governmental or self-regulatory body should receive direct reports from custodian banks that hold futures customer margin, as discussed in Leising (2012); and
- [5] There should be a rigorous re-examination of the protections provided to futures customers, including:
- improving and clarifying bankruptcy code priorities; and
 - determining whether futures customers should be covered by insurance like in Canada.*

* Source: <http://www.cipf.ca/public/NewsAndPublications/InformationsurMFGlobalCanada/MFGlobalCanadaQuestionsandAnswers.aspx>

3. Lessons Thus Far

- Two new board members of the National Futures Association (NFA) have also called for the following reforms:
 - “Making Seg[regated] Fund investments transparent in real-time ...”;
 - “Banning all non-exchange traded instruments for Seg Funds and prohibiting hypothecation ...”;
 - Potentially requiring “all customer funds [to] be held ... at the Clearing House”; and
 - Requiring FCM executives to “sign off daily on all Seg Fund balances and investments, with criminal penalties for any misrepresentation or malfeasance.”
- [The NFA is the self-regulatory organization of the U.S. futures industry.]

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