The MF Global Bankruptcy and Missing Customer Funds

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Summary

On October 31, 2011, MF Global, a large brokerage firm registered with the Securities and Exchange Commission (SEC) as a broker-dealer and with the Commodity Futures Trading Commission (CFTC) as a futures commission merchant (FCM), filed for bankruptcy. Details are lacking, but it appears that the firm failed as a result of losses from investments related to European sovereign debt.

Normally, brokerage customers are protected from brokerage failure. On the securities side, investors may receive up to $500,000 from the Securities Investor Protection Corporation (SIPC) if the failed brokerage’s assets are insufficient to meet customer claims. In futures markets, there is no insurance scheme comparable to SIPC, but customers are supposed to be protected by strict segregation rules: customer funds entrusted to FCMs are required to be kept in separate accounts and the FCM is not allowed to use them for its own purposes.

In the MF Global case, however, more than $900 million in customer funds were reported missing. (Subsequent estimates of the shortfall range from $600 million to $1.2 billion.) The CFTC, SEC, Justice Department, and the bankruptcy trustee are investigating and trying to locate the missing funds. Violation of segregation rules, if it occurred, is subject to civil and criminal penalties.

MF Global had about 50,000 futures customers with active accounts. About 17,000 of those accounts with open futures positions have been transferred to other FCM firms, in order that those customers may regain use of their funds. Customers who had cash accounts with MF Global, but not open futures positions, have had their money frozen. On November 17, 2011, the bankruptcy court approved distribution of $520 million, or about 60% of frozen customer funds. On December 9, 2011, the court approved a third distribution of about $2.1 billion in customer funds. When completed, customers should have received about 72% of their funds.

In the future, there may be additional partial payouts. Because the customer funds in cash accounts were not guaranteed, however, the final distribution of cash to investors may not occur until the conclusion of the bankruptcy proceeding, and it is not certain that MF Global’s futures customers will receive 100% of their money back.

This report provides information about MF Global, the rules for handling of customer funds, the enforcement of those rules, and the bankruptcy proceeding. It will be updated as events develop.
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Background

MF Global Holdings, Ltd. was one of the world’s leading brokers in markets for commodities and listed derivatives, providing clients with access to more than 70 exchanges globally. The firm was a leader by volume on many of the world’s largest derivatives exchanges. MF Global was also an active broker-dealer in markets for commodities, fixed income securities, equities, and foreign exchange. It was one of 20 primary dealers authorized to trade U.S. government securities with the Federal Reserve Bank of New York. Headquartered in the United States, the firm had operations in Australia, Canada, Hong Kong, India, Japan, Singapore, the United Kingdom, and other countries. In mid-2011, the firm reported total assets of $45.9 billion.

In the second quarter of 2011, MF Global reported total revenues of $611.2 million. Of this, $364.7 million (60%) was commissions and trading fees, $122.2 million (20%) was interest income (primarily net interest earned from customer margin funds held by the firm), and $116.8 million (19%) was attributable to principal transactions, or proprietary trading for the firm’s own account.

Although customer brokerage accounted for about 80% of MF Global’s revenue, the firm’s “strategic plan” called for a shift to an investment banking business model, in which proprietary trading and market making would become the principal sources of earnings. It appears that proprietary trading losses drove the firm into bankruptcy.

The precise nature of the trades that caused MF Global to fail remains unclear. In October 2011, the firm published a fact sheet disclosing that it held $6.4 billion in sovereign debt of five European countries, and that this position was financed through repurchase agreements. (A repurchase transaction, or repo, involves sale of a security with an agreement to buy it back later at a higher price. It is economically equivalent to a loan.) Some press reports suggest that the position was profitable to the extent that the interest rate MF Global paid on repos was lower than the rate paid by the sovereign bonds. If the cost of financing the bond position rose, MF Global would make a loss. In some versions, this is what happened: creditors insisted that MF Global post higher collateral against the position, either because the perceived credit risk of the bonds had increased or because MF Global’s own credit rating had been downgraded (which happened on October 24, 2011).

Whatever the immediate causes of the failure, the markets appear to have taken a pessimistic view of MF Global for some time. Its stock price, which began 2011 at about $8 per share, began to decline in May and fell below $4 on October 3. On Monday, October 24, Moody’s downgraded MF Global’s long-term debt to Baa3, the rating just above junk bond status. The next day, the stock price fell by 48%, from $3.55 to $1.86. On Friday, October 26, Standard & Poor’s placed

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1 This description (and the financial results that follow) are based on MF Global Holdings’ 10-Q quarterly report for the second quarter of 2011, filed with the Securities and Exchange Commission on August 3, 2011.
2 Ibid., p. 55.
4 Moody’s reported that it had “become increasingly concerned with MF Global’s risk management and management’s ability to prudently balance risk and reward as it undergoes a substantial re-engineering of the firm.” Moody’s Investors Service, “Rating Action: Moody’s downgrades MF Global to Baa3; reviews for further downgrade,” October 24, 2011.
MF Global on “credit watch negative,” meaning that a downgrade might be forthcoming. By that
time, the press was reporting that some banks were refusing to deal with MF Global and that
efforts were underway to sell the firm.5 Over the weekend, MF Global notified the CFTC that
more than $900 million in customer funds were unaccounted for, making a merger impractical
and blocking a mass transfer of customer futures accounts to stable FCMs. On Monday, October
31, MF Global filed for bankruptcy.

How the System Was Supposed To Work

The failure of a brokerage does not necessarily expose customers to loss. Both futures and
securities law and regulation provide safeguards to protect customer funds. Securities brokers
regulated by the Securities and Exchange Commission (SEC) are subject to a net capital rule—
they must cease operations before their assets fall below the level that allows customer claims to
be met. In addition, broker-dealers must belong to the Securities Investor Protection Corporation
(SIPC), which provides an insurance scheme whereby customers of failed broker-dealers may
receive up to $500,000 from the SIPC fund.

There is no analog to SIPC in futures markets regulated by the Commodity Futures Trading
Commission (CFTC). Instead, there are strict rules about the use of customer funds (in addition to
net capital rules). Section 4d(a)(2) of the Commodity Exchange Act (CEA) requires that customer
funds received by a futures commission merchant (FCM) to margin, guarantee, or secure a
customer’s futures contracts be held in segregated accounts, and not be commingled with the
funds of the FCM itself, nor used to guarantee the trades or contracts of any person other than the
customer.6 Thus, any MF Global losses related to its own proprietary trading should not have
affected customers. The shortfall of segregated customer funds is a rare event and represents a
breakdown of the system. “This has been a significant blemish on the industry’s reputation,” said
Dan Roth, president of the National Futures Association, an industry-funded self-regulatory
organization.7

Moreover, customers were taken off guard because, as FCM bankruptcy is usually handled, they
reasonably expected that their accounts would be transferred to another FCM, and that they
would be able to access their funds. Customers expected this based on historical precedent and a
feature of the bankruptcy code. Derivatives contracts, which include futures, are “qualified
financial contracts” under bankruptcy law. This means futures contracts are not subject to the
“automatic stay” that freezes other assets held by a bankrupt firm. One purpose of this exemption
is to enable customers to avoid premature liquidation of futures positions whose value depends on
often volatile movements of underlying commodities, as that could cause them to incur losses.8

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5  Jacon Bunge and Aaron Lucchetti, “MF Global Draws Interest as Tumultuous Week Ends,” Wall Street Journal,
October 28, 2011.
6  However, §4d(f)(3)(A) of the CEA does provide an exception permitting commingling “for convenience.” It is
unclear whether, and to what extent, this exception may have been invoked by MF Global. The funds that MF Global
should have held in segregation were primarily margin payments. All traders must post a few thousand dollars per
contract in margin before opening a futures position. The purpose of margin is to minimize the risk of default.
Customers post margin with FCMs and the FCMs post margin with the clearing house, which guarantees payment on
all contracts.
8  Details of how such transfers are permitted can be found in 17 C.F.R. §§ 190.01 through 190.10 (the “Part 190
(continued...)
On the weekend of October 29-30, before the bankruptcy filing, the CFTC was working to transfer MF Global customer accounts to another FCM. This attempt came to a halt with the disclosure at 2:30 a.m. on October 31 that segregated funds were missing—the second FCM would not accept futures positions without the associated margin. The requirement that all traders post margin to cover potential and actual losses is essential to the financial integrity of futures markets.

Subsequent to the bankruptcy, as discussed below, some customer accounts were transferred to other FCMs.

**Enforcement of Segregation Rules**

Any shortfall in segregated accounts violates the CEA and CFTC regulations. Violations may result in CFTC administrative sanctions, such as fines or bans from the futures industry, CFTC civil suits, or referral to the Justice Department for criminal prosecution. The CEA provides for fines of up to $1 million or five years imprisonment for each violation of the law.

As noted above, Section 4d of the CEA requires segregation of customer margin funds and prohibits FCMs from using those funds for their own purposes. In addition, 17 C.F.R. Section 1.32 ("Segregated account; daily computation and record") requires FCMs to compute daily both the amount of segregated funds on hand and the amount required to be held. Any shortfall must be reported immediately to the CFTC by telephone.

An FCM’s duty to maintain adequate funds in segregated accounts is the subject of reporting obligations and inspection. According to a February 2011 CME Group publication,

> Every day, FCMs must submit a report to the National Futures Association (NFA) detailing the breakdown of their customer funds. This “Segregated Investment Detail Report” (SIDR) lists the actual and expected segregated funds in the FCM’s accounts. In addition, every FCM must file monthly financial reports with the Commodity Futures Trading Commission’s Division of Clearing and Intermediary Oversight (DCIO) within 17 business days after the end of the month. Finally, the FCM is subject to a yearly audit by the Joint Audit Committee, a consortium of U.S. futures exchanges and regulatory organizations.

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9 CFTC, “Brief Description of Steps Taken by CFTC in MF Global,” handout at briefing for Senate staff, November 14, 2011.
10 17 C.F.R. §1.12 (“Maintenance of minimum financial requirements by futures commission merchants and introducing brokers”). As noted above, MF Global did report the missing funds by telephone.
The front-line policeman monitoring MF Global’s compliance was CME Group itself, acting as a self-regulatory organization. MF Global was a “clearing member” of the CME, meaning that it was part of the clearing house. According to a CME Group customer brochure,

CME Group’s Audit Department routinely inspects the books and records of clearing members to ensure, among other things, their compliance with segregation requirements. The integrity of segregation relies on the accuracy and timeliness of the information provided to CME Clearing by member firms. Violations by a clearing member of its segregation requirements are considered serious infractions and can result in major penalties imposed by the governing entity.12

The disappearance of customer funds raises questions about the adequacy of self-policing by FCMs and self-regulatory organizations (SROs), such as CME Group. In the securities markets, the Madoff Ponzi scheme led to calls for more active monitoring of customer accounts, including regular verification of the presence of customer assets by third parties, such as banks or depositories. Similar reforms might be considered in the futures area,13 as well as a more direct inspection role by the CFTC itself.

**Investment of Segregated Funds (Regulation 1.25)**

A separate issue dealing with segregated funds is how those funds may be invested within the segregated pool. While segregated funds are thought of as “cash,” they are not literally held in the form of currency. Traditionally, they have been invested in U.S. Treasury securities, in order that they generate interest income, which is shared between the customer and the FCM. In 2005, the CFTC broadened the range of permissible investments to include foreign sovereign debt, as well as other short-term debt instruments. In November 2010, the CFTC published a proposed regulation that would have tightened the definition of permissible investments. On December 5, 2011, the CFTC unanimously approved a final rule amending its Regulation 1.25 to prohibit investing customer margin funds in sovereign debt, in-house repurchase agreements, and certain forms of money market instruments.14

It is important to distinguish between investing customer funds in foreign sovereign debt and the investments MF Global made for its own account. The latter are not affected by the new Regulation 1.25. There is no evidence that investment losses within the pool of segregated assets were responsible for the shortfall in customer funds. Rather, it appears that funds were transferred out of the segregated pool and used for other purposes.

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13 In December 2010, the CFTC proposed a rule dealing with swap customer funds in bankruptcy, which appears to provide a stricter segregation standard for swaps than what now applies to futures. CFTC, “Protection of Cleared Swaps Customers Before and After Commodity Broker Bankruptcies,” *Federal Register*, vol. 75 (December 2, 2010), p. 75162.
The Bankruptcy Process

Because MF Global was an SEC-registered broker-dealer, its bankruptcy process is overseen by SIPC as well as the bankruptcy court. James W. Giddens, the SIPC trustee, will seek to identify and recover MF Global assets so that they may be distributed (with court approval) to customers and creditors. It does not appear that any client funds or securities were missing on the broker-dealer side of the firm. Instead, attention has focused on the futures customers, who may not recover all their funds.

According to press reports, MF Global had about 50,000 active futures customer accounts. These included accounts with open futures contracts and accounts with cash only. (Many futures traders close all their positions before the market closes each day to avoid overnight price risk. The next day, they may enter new trades up to the limit of their margin accounts. In the meantime, the cash stays in the segregated account at the FCM.) A problem for customers with cash accounts is that while the CME clearing house guarantees payment on all futures contracts, it does not guarantee all customer funds held by FCMs.

During the first week in November 2011, about 17,000 customer accounts with open positions were transferred to other FCMs. This was accompanied by a release of about $1.55 billion in collateral associated with those positions. According to the CME, “due to uncertainty over the amount of MF Global-held segregated funds to support customer trading, the Trustee only allowed CME Group to transfer customer positions to new clearing member firms with part, but not all, of their funds.”

Because of the possibility that futures customers may not receive 100% of the money that MF Global was supposed to have held in segregation, final distributions of cash to customers will be delayed until the trustee has a better understanding of the totality of creditor claims. A process for futures customers to file claims has been established. There may be several interim, partial distributions before the final payments are made.

The CFTC and the bankruptcy trustee are attempting to trace the missing customer funds. If they are able to identify specific transfers, out of segregated accounts and into other accounts, that money may be reclaimed exclusively for the benefit of the FCM customers. On the other hand, if no precise money trail can be established, FCM customers’ claims may be weighed along with claims of MF Global’s other creditors in the normal bankruptcy process.

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15 CFTC does not have legal authority to force an FCM into bankruptcy.
17 According to the SIPC trustee, this represented about 60% of the collateral associated with those positions at the time of the bankruptcy, and was the “maximum relief available under the law and the circumstances, and it averts mandatory liquidation of the transferred positions under governing CFTC rules.” See “Message to Former Customers of MF Global Inc.,” November 7, 2011. Online: http://dm.epiq11.com/MFG/Project/default.aspx.
The trustee has stated that he is unable to estimate when the investigation of the shortfall will be complete.\(^\text{19}\) The investigation involves the Department of Justice, the CFTC, and the SEC, as well as the trustee.

On November 17, 2011, the bankruptcy court approved a distribution of $520 million, or 60% of the $869 million that has been frozen since the bankruptcy. The payout, affecting 21,000 customers, was expected to be made by November 21.\(^\text{20}\)

The trustee next asked the court’s permission to distribute another $2.1 billion, which was substantially all the property still under the trustee’s control. The court approved this third distribution on December 9, 2011. When it is completed, futures customers are expected to have received about 72% of their assets.\(^\text{21}\)

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