



# The MF Global Bankruptcy, Missing Customer Funds, and Proposals for Reform

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August 1, 2013

**Congressional Research Service**

7-5700

[www.crs.gov](http://www.crs.gov)

R42091

**CRS Report for Congress**

*Prepared for Members and Committees of Congress*

## 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, marking the eighth-largest bankruptcy in U.S. history. Based on the subsequent investigation by the bankruptcy trustee, it appears that the firm failed as a result of a “run on the bank” by customers seeking withdrawals, combined with increased margin calls on the firm’s proprietary trading positions related to distressed European debt, which the firm could not meet.

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, about \$1.6 billion in customer funds were found to be missing after the bankruptcy. This consisted of about a \$900 million shortfall for domestic U.S. accounts at MF Global trading securities and commodities and a \$700 million shortfall related to trading by customers on foreign exchanges. The CFTC, SEC, Justice Department, and the bankruptcy trustee investigated to locate the missing funds and determine causes of the loss. During the investigation, the bankruptcy trustee found that customer funds had been wired to various banks and trading partners of MF Global to meet overdrafts and collateral calls. As of June 2013, the trustee announced that 89% of U.S. futures customers’ funds had been located and returned. The trustee anticipated that figure would reach 94% once certain legal agreements were acted upon. However, for futures customers overseas, or who had had accounts set up in which to trade on foreign exchanges, the figure was significantly lower, with only 18% of their missing funds returned as of June 4, 2013, albeit with an ultimate expected return rate of 84%-91%, according to the trustee.

Violation of segregation rules can be subject to civil and criminal penalties. The CFTC launched a civil lawsuit for monetary penalties in June 2013 against the firm and its former CEO, Jon Corzine, and former Assistant Treasurer, Edith O’Brien. Numerous private lawsuits have also been commenced, and some have been settled. However, no criminal charges have been filed.

The MF Global failure raised questions about whether enforcement mechanisms for segregation of futures market customer funds were reliable—particularly in times of unusual stress. It also provided an opportunity to evaluate the effectiveness of regulatory cooperation during a rapid failure of a large, complex financial institution. It prompted a number of policy questions: is the enforcement of segregation requirements for futures customers’ accounts sufficient for unusual market conditions, such as a run? Should some type of SIPC-like insurance, such as is offered for customers of securities broker-dealers, be contemplated for futures customers or would costs be too great? The CFTC on November 14, 2012, proposed a rule aimed at increasing disclosure requirements for futures brokers to give customers greater accounting for their funds.

This report provides information about MF Global’s failure, the rules for handling of customer funds, the enforcement of those rules, the bankruptcy proceeding, related policy issues and reform proposals to ensure greater protections for futures customers. It will be updated as events warrant.

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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.<sup>1</sup> 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.<sup>2</sup> It appears that market concerns over proprietary trading losses related to European sovereign debt in the fall of 2011 ultimately sparked both customer withdrawals and, separately, demands that MF Global post additional margin to cover risks from the firm's trading positions. These sudden, pronounced demands for liquidity, which the firm could not meet, led to the misuse of customer funds and drove the firm into bankruptcy, according to the investigation by the bankruptcy trustee.<sup>3</sup> In the words of the trustee, "the simultaneous occurrence of a customer 'run on the bank' and unwinds of repo counterparty and proprietary positions within a three-day timeframe overwhelmed the Firm ... The speed at which events transpired was beyond management's predictions—the worst—case scenario played out in the span of only a few days."<sup>4</sup>

The trades that led to losses, and market fears over losses, accompanied by large margin calls that strained MF Global's liquidity stemmed from complex trades related to European sovereign debt. (Please see **Figure B-2** for details of the increased margin calls.) These trades focused on debt from Ireland, Italy, Portugal, and Spain, all of which had begun experiencing severe financial distress.<sup>5</sup> 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

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<sup>1</sup> This description (and the financial results that follow) is 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.

<sup>2</sup> MF Global Holdings' 10-Q quarterly report for the second quarter of 2011, filed with the Securities and Exchange Commission on August 3, 2011, p. 55.

<sup>3</sup> *In Re MF Global Inc., Report of the Trustee's Investigation and Recommendation*, Attorneys for James W. Giddens, Trustee for the SIPA Liquidation of MF Global Inc., Case No. 11-2790 (MG) SIPA (U.S. Bankruptcy Court for the Southern District of New York) June 2012, available at <http://www.cftc.gov/ucm/groups/public/@newsroom/documents/file/mfglobalinvestreport060412.pdf>.

<sup>4</sup> *Report of the Trustee's Investigation and Recommendation*, p. 149.

<sup>5</sup> *Report of the Trustee's Investigation and Recommendation*, p. 8.

agreements.<sup>6</sup> (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.) According to the bankruptcy trustee's investigation later, MF Global's exposure to sovereign European debt "was more than four and a half times MF Global's total equity, a level that was orders of magnitude greater than the relative exposure at other, larger financial institutions."<sup>7</sup>

Some press reports suggested that the position was profitable to the extent that the interest rate MF Global paid on these repos was lower than the rate paid by the sovereign bonds. If the cost of financing the bond position rose, MF Global would take a loss. In a sense, 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).

The markets appear to have taken a pessimistic view of MF Global for some time prior to the bankruptcy. Its stock price, which started 2011 at about \$8 per share, began to decline in May and fell below \$4 on October 3. On Monday, October 24, 2011, Moody's downgraded MF Global's long-term debt to Baa3, the rating just above junk bond status.<sup>8</sup> The next day, the stock price fell by 48%, from \$3.55 to \$1.86. On Friday, October 26, Standard & Poor's placed MF Global on "credit watch negative," meaning that a downgrade might be forthcoming. On October 27, Moody's cut MF Global's credit rating to junk status. 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.<sup>9</sup> Over that weekend, MF Global notified the Commodity Futures Trading Commission (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 futures commission merchants (FCMs). On Monday, October 31, 2011, MF Global filed for bankruptcy.

Subsequent to the bankruptcy, a \$1.6 billion shortfall in customer funds was identified by the bankruptcy trustee.<sup>10</sup> This consisted of a \$900 million shortfall for domestic U.S. accounts trading both commodities and securities and a \$700 million shortfall related to trading by customers on foreign exchanges.<sup>11</sup>

Following a lengthy bankruptcy investigation to track missing customer funds, customers received some of their missing funds in installments. As of June 4, 2013, the bankruptcy trustee announced that U.S. futures customers had received 89% of their missing funds, and that he anticipated that figure should reach 94% once certain legal agreements were acted upon.<sup>12</sup> However, for futures customers overseas, or who had had accounts set up in which to trade on

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<sup>6</sup> MF Global, "Short-Term European Sovereign Portfolio," October 2011, available at <http://phx.corporate-ir.net/External.File?item=UGFyZW50SUQ9NDQ0MTE1fENoaWxkSUQ9NDY3MDg2fFR5cGU9MQ==&t=1>.

<sup>7</sup> *Report of the Trustee's Investigation and Recommendation*, p. 8.

<sup>8</sup> 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.

<sup>9</sup> Jacon Bunge and Aaron Lucchetti, "MF Global Draws Interest as Tumultuous Week Ends," *Wall Street Journal*, October 28, 2011.

<sup>10</sup> *Report of the Trustee's Investigation and Recommendation*, p. 3.

<sup>11</sup> *Ibid.*, p. 3.

<sup>12</sup> *In Re MF Global Inc., Trustee's Third Six Month Interim Report for the Period December 5, 2012 Through June 4, 2013*, Attorneys for James W. Giddens, Trustee for the SIPA Liquidation of MF Global Inc., Case No. 11-2790 (MG) SIPA (U.S. Bankruptcy Court for the Southern District of New York) June 2013, p. 1.

foreign exchanges, the figure was significantly lower, with only 18% of their missing funds returned as of June 4, 2013.<sup>13</sup> The trustee estimated, however, that anticipated legal agreements should allow distributions for these customers trading on foreign exchanges to ultimately reach 84%-91% of their original customer funds.<sup>14</sup>

After investigations into the failure and the missing customer funds by the two bankruptcy trustees, the CFTC, Securities and Exchange Commission (SEC), and Department of Justice, no criminal charges have been filed against MF Global or any of its officers. However, the CFTC on June 27, 2013, filed a civil lawsuit naming as defendants MF Global Inc., the futures commission merchant; MF Global Holdings Ltd., the parent holding company; the former Chief Executive Officer (CEO) Jon Corzine; and the former Assistant Treasurer Edith O'Brien. In addition, bankruptcy trustee Louis Freeh, the trustee for the holding company, has filed a civil lawsuit on behalf of the estate against Corzine, former Chief Operating Officer (COO) Bradley Abelow, and former Chief Financial Officer (CFO) Henri Steenkamp. The defendants filed a motion to dismiss the lawsuit on July 22, 2013.<sup>15</sup> There are numerous other private lawsuits against the firm, its directors, and officers still pending.

The CFTC seeks monetary penalties against the defendants<sup>16</sup> and a ban from the futures industry. The CFTC complaint alleges, among other charges, that, “as liquidity stresses increased in 2011, Corzine directed the firm to explore using customer funds.”<sup>17</sup> The CFTC also charges that O'Brien “directed, approved, and/or caused multiple unlawful transfers from customer segregated accounts.”<sup>18</sup> Relying partly on internal recorded telephone calls, including by Corzine and by O'Brien, the CFTC complaint paints a picture of officers within the firm increasingly desperate to cover the firm's overdrafts and collateral calls to keep it from collapsing, and increasingly willing to dip into customer funds to do so.<sup>19</sup> It will likely take months or years for the numerous civil lawsuits to be resolved or settled out of court.

## 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 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),

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<sup>13</sup> *Trustee's Third Six Month Interim Report for the Period December 5, 2012 Through June 4, 2013*, p. 2.

<sup>14</sup> *Trustee's Third Six Month Interim Report for the Period December 5, 2012 Through June 4, 2013*, p. 2.

<sup>15</sup> *Louis J. Freeh, As Chapter 11 Trustee of MF Global Holdings Ltd. v. Jon Corzine, Bradley Abelow, and Henri Steenkamp*, Case No. 11-15059 (MG) (U.S. Bankruptcy Court Southern District of New York) 2013.

<sup>16</sup> Of roughly \$140,000 for each violation of the Commodity Exchange Act and of CFTC Regulations by each defendant (or triple the monetary gain to that defendant, plus post-judgment interest—whichever is higher). See *U.S. Commodity Futures Trading Commission v. MF Global Inc., MF Global Holdings Ltd, Jon S. Corzine, and Edith O'Brien*, Civil Action, “Complaint for Injunctive and Other Equitable Relief and for Civil Monetary Penalties Under the Commodity Exchange Act” (U.S. District Court Southern District of New York), June 27, 2013 filing, p. 46. Available at <http://www.cftc.gov/ucm/groups/public/@lrenforcementactions/documents/legalpleading/enfmfglobalcomplaint062713.pdf>.

<sup>17</sup> *Ibid.*, p. 14.

<sup>18</sup> *Ibid.*, p. 32.

<sup>19</sup> See *CFTC Complaint*, Section IV. Facts, p. 8.

which provides an insurance scheme whereby customers of failed broker-dealers may receive up to \$500,000 from the SIPC fund. Please see **Figure A-1** for a detailed chart showing the complex web of regulatory oversight of MF Global by both regulators and self-regulatory organizations.

There is no analog to SIPC in futures markets regulated by the 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 FCM to margin, guarantee, or secure a customer's futures contracts be held in segregated accounts,<sup>20</sup> 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.<sup>21</sup> 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 (NFA), an industry-funded self-regulatory organization.<sup>22</sup>

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.<sup>23</sup>

On the weekend of October 29-30, 2011, 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.<sup>24</sup> 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.

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<sup>20</sup> 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.

<sup>21</sup> However, §4d(f)(3)(A) of the CEA does provide an exception permitting commingling "for convenience." From the bankruptcy trustee's investigation, it appears that MF Global made use of this exception.

<sup>22</sup> As reported in Greg Meyer, "MF Global fallout revives regulatory calls," *Financial Times*, November 10, 2011.

<sup>23</sup> Details of how such transfers are permitted can be found in 17 C.F.R. §§190.01 through 190.10 (the "Part 190 Regulations"), and in Reg. 190.06(g). See "Emergency Motion Of James W. Giddens, Trustee For The Liquidation Of MF Global Inc., For An Order Approving The Transfer Of Certain Segregated Customer Commodity Positions And Extending The Trustee's Authorization To Operate The Business Of MF Global Inc. In The Ordinary Course," Case No. 11-2790 (MG) SIPA.

<sup>24</sup> CFTC, "Brief Description of Steps Taken by CFTC in MF Global," handout at briefing for Senate staff, November 14, 2011.

## 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 10 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.<sup>25</sup>

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.<sup>26</sup>

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.<sup>27</sup>

The disappearance of customer funds raised 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,<sup>28</sup> as well as a more direct inspection role by the CFTC itself.

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<sup>25</sup> 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.

<sup>26</sup> “Safeguarding Customers Through Segregated Funds,” *Managed Futures Today*, February 2011, available at <http://www.cmegroup.com/managed-futures/Feb2011/safeguarding-customers-through-segregated-funds.html>. (CME Group, formerly the Chicago Mercantile Exchange, is the largest futures exchange in the world. It has regulatory responsibilities as a “self-regulatory organization.”)

<sup>27</sup> “CME Clearing Financial Safeguards,” p. 10, at <http://www.cmegroup.com/clearing/files/financialsafeguards.pdf>.

<sup>28</sup> 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 (continued...)”



## 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. Although 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 to 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.<sup>29</sup>

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.

## 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.<sup>30</sup> 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. Please see **Figure A-2** for a chart breaking down the dual responsibilities of the two bankruptcy trustees for MF Global.

According to press reports, MF Global had about 50,000 active futures customer accounts.<sup>31</sup> 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 although the Chicago Mercantile Exchange (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

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(...continued)

Swaps Customers Before and After Commodity Broker Bankruptcies,” *75 Federal Register* 75162, December 2, 2010.

<sup>29</sup> Richard Hill, “CFTC Adopts Rule Tightening Investments Permissible With Client Funds,” *BNA Daily Report for Executives*, December 6, 2011.

<sup>30</sup> CFTC does not have legal authority to force an FCM into bankruptcy.

<sup>31</sup> Jerry DiColo, Dan Strumpf, and Gina Chon, “Purgatory for MF Global Customers,” *Wall Street Journal*, November 16, 2011, p. C2.

collateral associated with those positions.<sup>32</sup> 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.”<sup>33</sup>

The restoration of missing customer funds has been a lengthy process. On November 17, 2011, the bankruptcy court approved a distribution of \$520 million, or 60% of the \$869 million that was frozen since the bankruptcy. The payout, affecting 21,000 customers, was made November 21.<sup>34</sup> 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 at that time. The court approved this third distribution on December 9, 2011. When completed, futures customers were estimated to have received about 72% of their assets.<sup>35</sup> As discussed, as of June 4, 2013, the bankruptcy trustee reported that U.S. futures customers had received 89% of their funds, and he anticipated that figure should reach 94% after certain legal agreements were acted upon.

## Proposals for Change

The MF Global failure raised questions about whether enforcement mechanisms for segregation of futures market customer funds were reliable—particularly in times of unusual stress. It also provided an opportunity to evaluate the effectiveness of regulatory cooperation during a rapid failure of a large, complex financial institution. It prompted certain policy questions, including is the enforcement of segregation requirements for futures customers’ accounts sufficient for unusual market conditions, such as a run? Should some type of SIPC-like insurance,<sup>36</sup> such as is offered for customers of securities broker-dealers, be contemplated for futures customers, or would costs be too great? Should the regulatory requirements for customer segregated funds aimed at investing on foreign exchanges be made more uniform with requirements for customer funds invested on U.S. exchanges?

Calls for reform have been further fueled by the failure in July 2012 of futures trading firm Peregrine Financial Group Inc. On January 31, 2013, Russell Wasendorf Sr., the founder and former CEO of Peregrine, was sentenced to 50 years in prison after being convicted of stealing more than \$215 million from customers of that failed brokerage. The failure of Peregrine, and subsequent loss of its futures customers’ funds, further underscored the need to revisit whether measures to protect futures customers’ funds were adequate. The NFA, the self-regulatory

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32 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, available at <http://dm.epiq11.com/MFG/Project/default.aspx>.

33 CME Group Advisory Notice 11-415, “Update on Transfers of MF Global Inc. Customer Positions and Collateral - Revised - 11/15/2011.”

34 “Judge OKs \$520 Million Payout to MF Global Customers,” *Reuters*, November 17, 2011, at [http://www.nytimes.com/reuters/2011/11/17/business/business-us-mfglobal-payout.html?\\_r=1&hp](http://www.nytimes.com/reuters/2011/11/17/business/business-us-mfglobal-payout.html?_r=1&hp).

35 “Statement from the Office of the Trustee for the Liquidation of MF Global Inc. On Judge’s Approval of Third Transfer and Securities Accounts Sale,” press release, December 9, 2011, available at <http://dm.epiq11.com/MFG/Project/default.aspx>.

36 Securities 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.

organization, came under criticism for failing to catch a shortfall in customer segregated account funds even though it was the front-line auditor of Peregrine.<sup>37</sup>

In response to the MF Global and Peregrine failures, the CFTC on November 14, 2012, proposed a rule aimed at increasing disclosure requirements for futures brokers to give customers greater accounting for their funds.<sup>38</sup> The proposal arguably would require heightened disclosure by brokers about how client collateral is held at custodial banks and increase standards for auditors of brokerages.<sup>39</sup> Industry groups, however, have complained that the proposed rule would impose excessive costs.<sup>40</sup> The CFTC, in finalizing its proposed rule, would presumably weigh industry concerns that stricter safeguards could tie up additional capital and raise costs for futures customers with the policy goals of improving protections for customer funds.<sup>41</sup>

Also in response to these failures, a formal study on the creation of a SIPC-like insurance fund for futures customers was launched in December 2012 by trade groups and SROs, including the NFA, the Futures Industry Association, the CME, and academics at the University of Chicago Booth School of Business.<sup>42</sup> The study is expected to focus on the costs, scope, and feasibility of such an insurance fund, and it is expected to be released by fall of 2013, according to press reports.<sup>43</sup>

Additional suggestions for reforms include a recommendation by the bankruptcy trustee James Giddens that the regulatory regime under CFTC rules for treatment of customer funds for trades on foreign exchanges be made more uniform with the regime requiring stricter segregation of futures customers' funds that are kept for trading in U.S. markets.<sup>44</sup> Giddens noted that MF Global had exploited these differences in regulatory requirements for U.S. segregated funds (dubbed "4d funds" after Section 4d of the CEA) and funds by U.S. customers in accounts designated for foreign trading (dubbed "30.7 funds" for a different rule on their regulatory treatment) and had dipped into these 30.7 funds even more deeply.<sup>45</sup> As a result, Giddens found "virtually no money had been actually segregated for customers" with these foreign, or "30.7" funds—creating an even larger overall shortfall in missing customer accounts.<sup>46</sup>

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<sup>37</sup> Arash Massoudi, "Regulator Admits Peregrine Failure," *Financial Times*, July 17, 2012, at <http://www.ft.com/cms/s/0/7f7c2d74-d027-11e1-bcaa-00144feabdc0.html#axzz2SoVzKRcp>.

<sup>38</sup> CFTC, "Enhancing Protections Afforded Customers and Customer Funds Held by Futures Commission Merchants and Derivatives Clearing Organizations; Proposed Rule," 77 *Federal Register* 67866, November 14, 2012.

<sup>39</sup> For more on the proposal, see Silla Brush, "MF Global Customer Funds Rules Get Another CFTC Hearing," *Bloomberg*, February 5, 2013, at <http://www.bloomberg.com/news/2013-02-05/mf-global-customer-funds-rules-get-another-cftc-hearing.html>.

<sup>40</sup> Silla Brush, "Futures Brokers Say Rule May Put Them Out of Business," *Bloomberg*, March 7, 2013, at <http://www.bloomberg.com/news/2013-02-15/mf-global-cftc-proposal-said-to-jeopardize-futures-brokerages.html>.

<sup>41</sup> See Ann Saphir, "U.S. CFTC Looks Set to Keep Margin Rules Despite Industry Outcry," *Reuters*, July 25, 2013, available at <http://www.reuters.com/article/2013/07/25/financial-regulation-cftc-margins-idUSL1N0FV1HD20130725>.

<sup>42</sup> Jacob Bunge, "Futures Sector Divided Over Insurance Fund," *Wall Street Journal*, March 14, 2013, available at <http://online.wsj.com/article/SB10001424127887324532004578360420404436666.html>.

<sup>43</sup> *Ibid.*

<sup>44</sup> James W. Giddens, "How To Avoid the Next MF Global Surprise," *Opinion, Wall Street Journal*, July 9, 2013.

<sup>45</sup> *Ibid.*

<sup>46</sup> *Ibid.*

## Appendix A. MF Global's Regulatory Oversight and Bankruptcy Proceedings

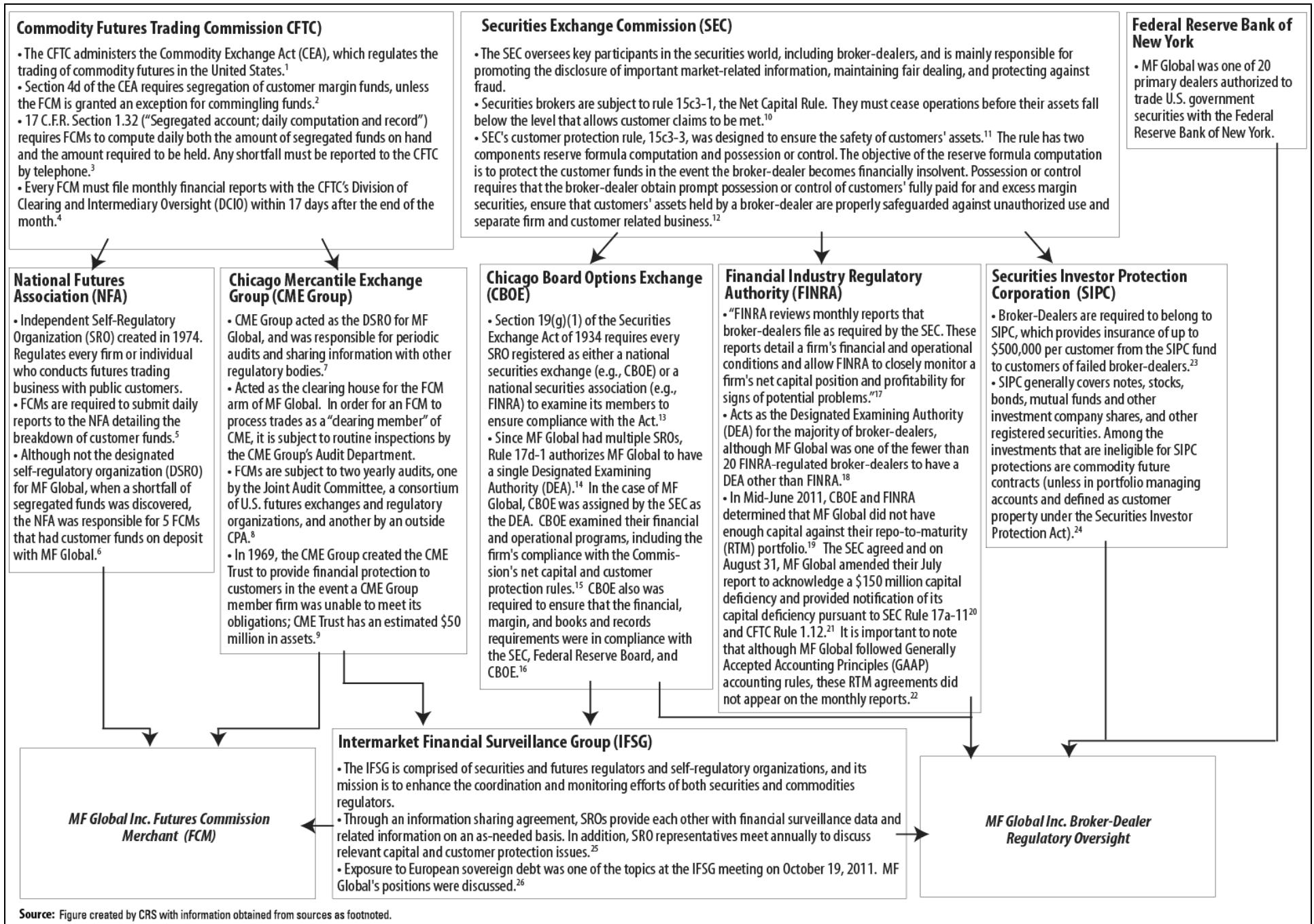
**Figure A-1** details the regulatory oversight of MF Global prior to its bankruptcy. The left side of the chart shows the regulatory oversight of the FCM business and the right side shows the regulatory oversight of the broker-dealer business.

**Figure A-2** details the trustees assigned to handle the bankruptcy proceedings. The trustee for MF Global Inc. was responsible for recovering customer funds, while the trustee for MF Global Holdings was responsible for recovering the funds for unsecured creditors.<sup>12</sup> **Figures B-1, B-2,** and **B-3** provide details and a timeline for cash movement out of MF Global, based on the trustee's investigation.

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<sup>12</sup> See official website for Chapter 11 bankruptcy proceedings for MF Global entities, available at <http://www.mfglobalcaseinfo.com/info.php>.

**Figure A-I. Regulatory Oversight of MF Global**



<sup>1</sup> 7 U.S.C. § 1, et seq. – “Commodity Exchange Act.” Available at: <http://www.cftc.gov/LawRegulation/CommodityExchangeAct/index.htm>.

<sup>2</sup> 7 U.S.C. § 6d – “Dealing by unregistered futures commission merchants or introducing brokers prohibited; duties in handling customer receipts; rules to avoid duplicative regulations.”

<sup>3</sup> 17 C.F.R. § 1.12 – “Maintenance of minimum financial requirements by futures commission merchants and introducing brokers. MF Global did report the missing funds by telephone.”

<sup>4</sup> “Safeguarding Customers Through Segregated Funds,” *Managed Futures Today*, February 2011, available at: <http://www.cmegroup.com/managed-futures/Feb2011/safeguarding-customers-through-segregated-funds.html>.

<sup>5</sup> *Ibid.*

<sup>6</sup> Testimony Daniel Roth, President and CEO of the National Futures Association (NFA), in U.S. Congress, House Committee on Agriculture, Examination of MF Global Bankruptcy, hearing, 112th Cong., 2nd sess., (December 8, 2011), available at <http://agriculture.house.gov/pdf/hearings/Roth111208.pdf>.

<sup>7</sup> Testimony Terrence A. Duffy, executive chairman CME Group Inc., in U.S. Congress, House Committee on Agriculture, Examination of MF Global Bankruptcy, hearing, 112th Cong., 2nd sess., (December 8, 2011), available at <http://agriculture.house.gov/pdf/hearings/Duffy111208.pdf>.

<sup>8</sup> Testimony Daniel Roth, President and CEO of the National Futures Association (NFA), in U.S. Congress, House Committee on Agriculture, Examination of MF Global Bankruptcy, hearing, 112th Cong., 2nd sess., (December 8, 2011), available at <http://agriculture.house.gov/pdf/hearings/Roth111208.pdf>.

<sup>9</sup> Testimony Terrence A. Duffy, executive chairman CME Group Inc., in U.S. Congress, House Committee on Agriculture, Examination of MF Global Bankruptcy, hearing, 112th Cong., 2nd sess., (December 8, 2011), available at <http://agriculture.house.gov/pdf/hearings/Duffy111208.pdf>.

<sup>10</sup> 17 C.F.R. § 240.15c3-1 – “Net capital requirements for brokers or dealers.”

<sup>11</sup> 17 C.F.R. § 240.15c3-3 – “Customer protection-reserves and custody of securities.”

<sup>12</sup> Testimony Stephen Luparello, Vice Chairman of FINRA, in U.S. Congress, House Committee on Agriculture, Examination of MF Global Bankruptcy, hearing, 112th Cong., 2nd sess., (December 8, 2011), available at <http://agriculture.house.gov/pdf/hearings/Luparello111208.pdf>.

<sup>13</sup> Codified at 15 U.S.C. § 78s – “Registration, responsibilities, and oversight of self-regulatory organizations.” See also Testimony Stephen Luparello, Vice Chairman of FINRA, in U.S. Congress, House Committee on Agriculture, Examination of MF Global Bankruptcy, hearing, 112th Cong., 2nd sess., (December 8, 2011), available at <http://agriculture.house.gov/pdf/hearings/Luparello111208.pdf>.

<sup>14</sup> 17 C.F.R. § 240.17d-1 – “Examination for compliance with applicable financial responsibility rules.”

<sup>15</sup> Testimony Stephen Luparello, Vice Chairman of FINRA, in U.S. Congress, House Committee on Agriculture, Examination of MF Global Bankruptcy, hearing, 112th Cong., 2nd sess., (December 8, 2011), available at <http://agriculture.house.gov/pdf/hearings/Luparello111208.pdf>.

<sup>16</sup> Testimony William J. Brodsky, Chairman and CEO of CBOE Holdings, Inc., in U.S. Congress, House Committee on Agriculture, Examination of MF Global Bankruptcy, hearing, 112th Cong., 2nd sess., (December 8, 2011), available at: <http://agriculture.house.gov/pdf/hearings/Brodsky111208.pdf>.

<sup>17</sup> *Ibid.*

<sup>18</sup> *Ibid.*

<sup>19</sup> RTMs are essentially transactions whereby the maturity date of a firm's bond position held in its inventory matches the maturity date of the repo, Stephen Luparello, Vice Chairman of FINRA, Testimony on December 8, 2011 to the House Committee on Agriculture. <http://agriculture.house.gov/pdf/hearings/Luparello111208.pdf>.

<sup>20</sup> 17 C.F.R. § 240.17a-11 – “Notification provisions for brokers and dealers.”

<sup>21</sup> 17 C.F.R. § 1.12 – “Maintenance of minimum financial requirements by futures commission merchants and introducing brokers.”

<sup>22</sup> Testimony William J. Brodsky, Chairman and CEO of CBOE Holdings, Inc., in U.S. Congress, House Committee on Agriculture, Examination of MF Global Bankruptcy, hearing, 112th Cong., 2nd sess., (December 8, 2011), available at: <http://agriculture.house.gov/pdf/hearings/Brodsky111208.pdf>.

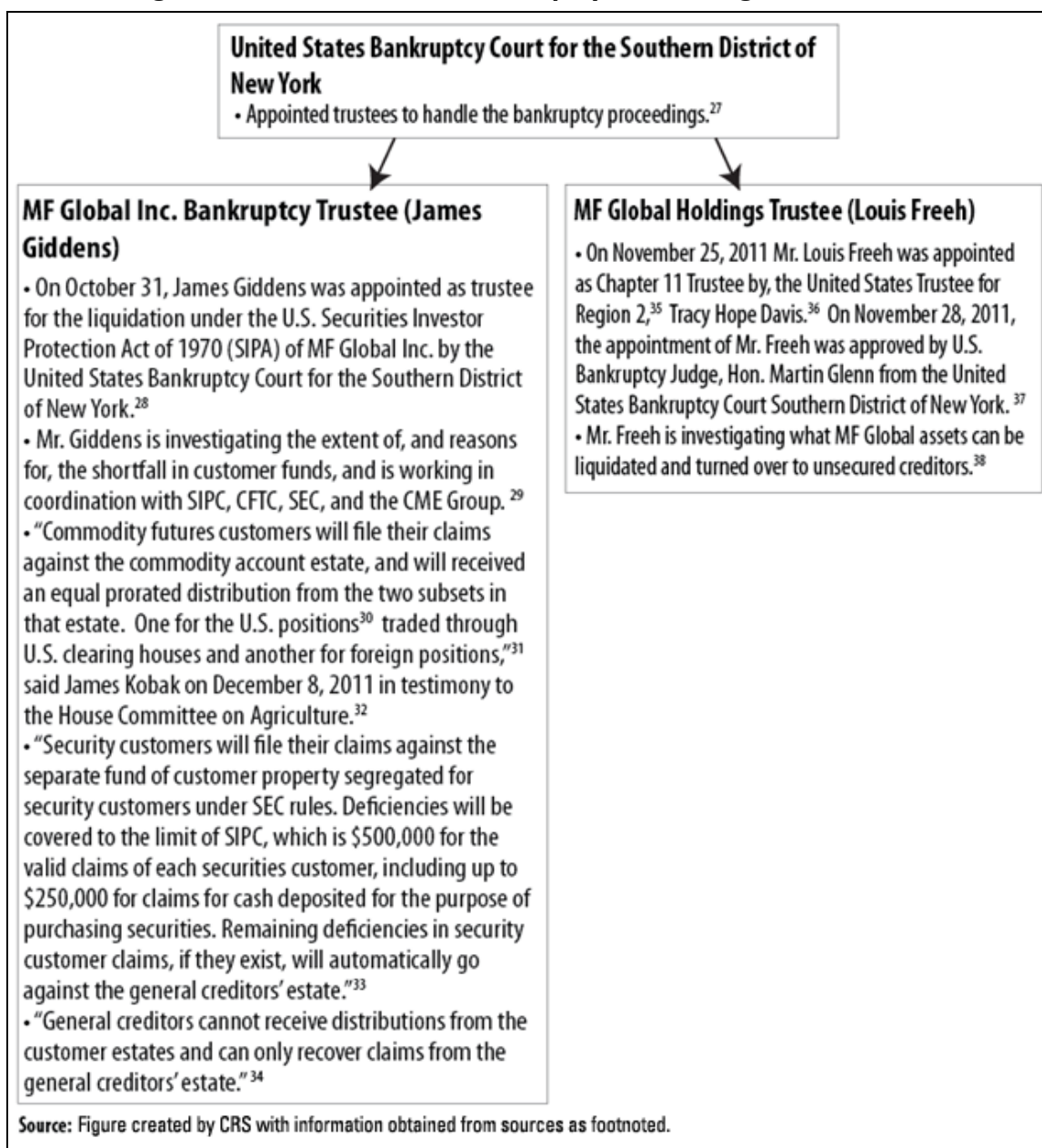
<sup>23</sup> 15 U.S.C. § 78ccc – “Securities Investor Protection Corporation.”

<sup>24</sup> Testimony William J. Brodsky, Chairman and CEO of CBOE Holdings, Inc., in U.S. Congress, House Committee on Agriculture, Examination of MF Global Bankruptcy, hearing, 112th Cong., 2nd sess., (December 8, 2011), available at: <http://agriculture.house.gov/pdf/hearings/Brodsky111208.pdf>.

<sup>25</sup> Testimony Stephen Luparello, Vice Chairman of FINRA, in U.S. Congress, House Committee on Agriculture, Examination of MF Global Bankruptcy, hearing, 112th Cong., 2nd sess., (December 8, 2011), available at

<sup>26</sup> Testimony Richard Ketchum, Chairman and CEO of FINRA, in U.S. Congress, House Committee on Financial Services, the Subcommittee on Oversight and Investigations Committee on Financial Services, The Collapse of MF Global, hearing, 112th Cong., 2nd sess., (December 15, 2011), <http://financialservices.house.gov/UploadedFiles/121511ketchum.pdf>.

Figure A-2. Trustees of the Bankruptcy Proceedings of MF Global



<sup>27</sup>See official website for SIPA liquidation of MF Global, Inc. Available at: <http://dm.epiq11.com/MFG/Project/default.aspx>. See also, official website for Chapter 11 bankruptcy proceedings for MF Global entities. Available at: <http://www.mfglobalcaseinfo.com/info.php>.

<sup>28</sup>Official website for SIPA liquidation of MF Global, Inc. Available at: <http://dm.epiq11.com/MFG/Project/default.aspx>.

<sup>29</sup>Progress Report of the SIPA Trustee of MF Global Inc., Nov. 7, 2011. Available at: [http://dm.epiq11.com/MFG/Project/default.aspx#Section2\\_6](http://dm.epiq11.com/MFG/Project/default.aspx#Section2_6)

<sup>30</sup>The U.S. funds are often referred to as “Rule 4(d) segregated funds.” They relate to section 4(d) of the Commodity Exchange Act, codified at 7 U.S.C. § 6d – “Dealing by unregistered futures commission merchants or introducing brokers prohibited; duties in handling customer receipts; rules to avoid duplicative regulations.” Additional rules on these segregated funds can be found at 17 C.F.R. §§ 1.20 – 1.25.

<sup>31</sup>Foreign funds are often referred to as “Rule 30.7 secured funds,” codified at 17 C.F.R. § 30.7 – “Treatment of foreign futures or foreign options secured amount.”

<sup>32</sup>Testimony James Kobak, Counsel for the Trustee for the Securities Protection Act Liquidation of MF Global Inc., in U.S. Congress, House Committee on Agriculture, Examination of MF Global Bankruptcy, hearing, 112th Cong., 2nd sess., (December 8, 2011), available at: <http://agriculture.house.gov/pdf/hearings/Kobak111208.pdf>.

<sup>33</sup>*Ibid*, p. 4.

<sup>34</sup>*Ibid*, p. 4.

<sup>35</sup>“The United States Trustee for Region 2 serves the federal judicial districts established for New York, Connecticut and Vermont.” Available at: <http://www.justice.gov/ust/r02/>.

<sup>36</sup>Official Website for Chapter 11 bankruptcy proceedings for MF Global entities, Docket 169. Available at: [http://mfglobalcaseinfo.com/pdflib/169\\_15059.pdf](http://mfglobalcaseinfo.com/pdflib/169_15059.pdf).

<sup>37</sup>Official Website for Chapter 11 bankruptcy proceedings for MF Global entities, Docket 170. Available at: [http://mfglobalcaseinfo.com/pdflib/170\\_15059.pdf](http://mfglobalcaseinfo.com/pdflib/170_15059.pdf).

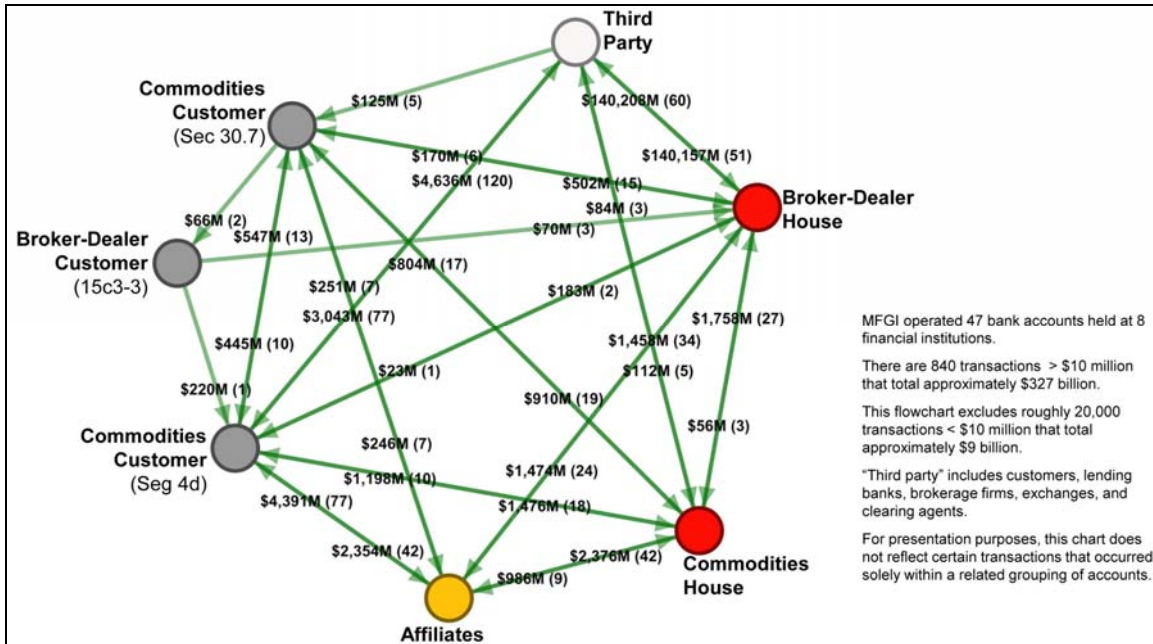
<sup>38</sup>Ed Beeson. “From FBI to MF Global: Louis Freeh finds role in bankruptcy fray.” *The Star Ledger*, Feb. 19, 2011. Available at: [http://www.nj.com/business/index.ssf/2012/02/from\\_fbi\\_to\\_mf\\_global\\_louis\\_fr.html](http://www.nj.com/business/index.ssf/2012/02/from_fbi_to_mf_global_louis_fr.html). See also official website for Chapter 11 bankruptcy proceedings for MF Global entities. Available at: <http://www.mfglobalcaseinfo.com/info.php>.



## Appendix B. Money Movements at MF Global

**Figure B-I. Consolidated Overview of Cash Movement**

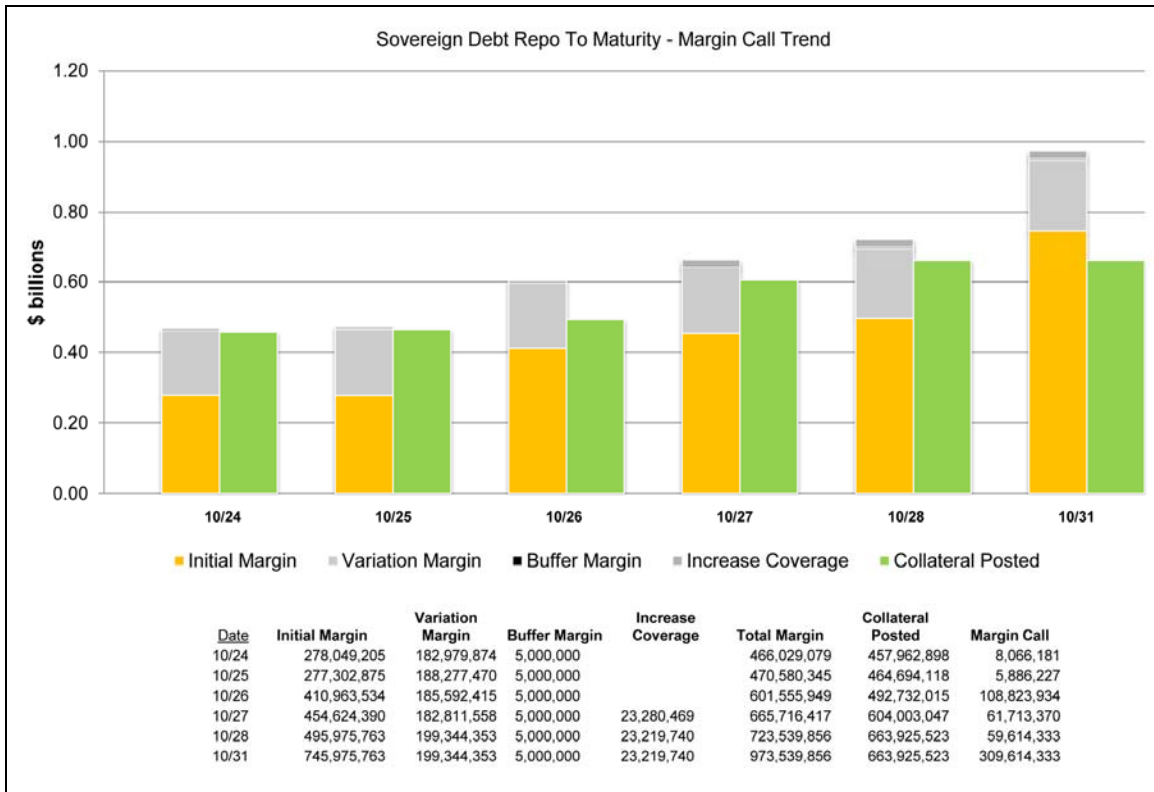
MF Global Inc., October 1-31, 2011



**Source:** February 6, 2012 status update from the Office of James Giddens, trustee for the liquidation of MF Global Inc.

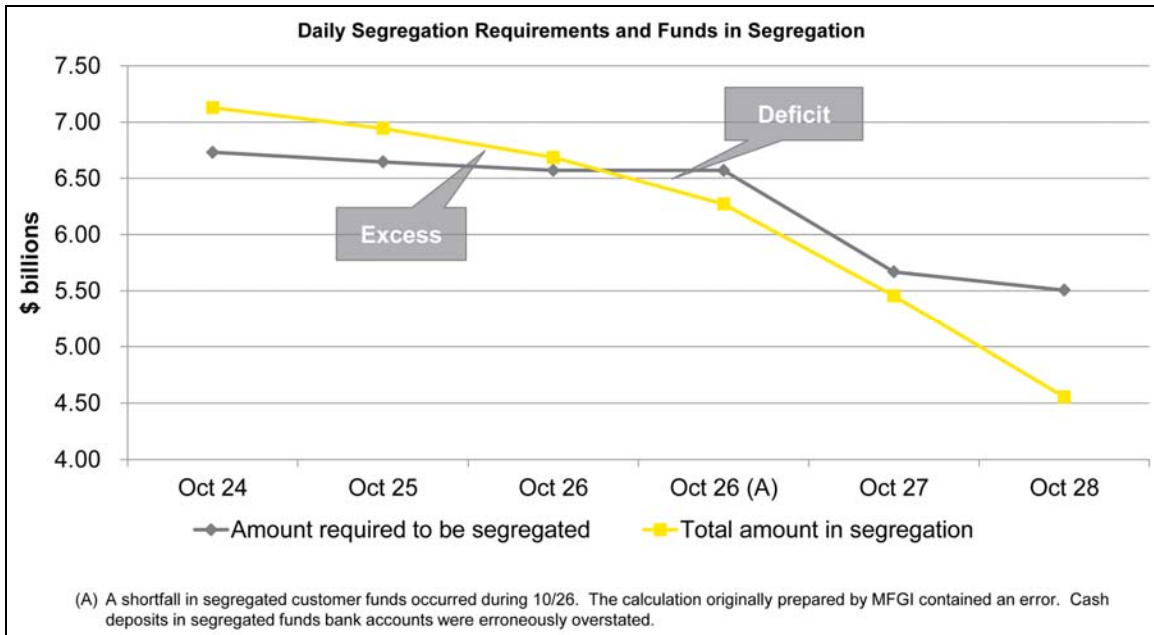
**Notes:** Chart reflects cash movement only. Investigation was ongoing to trace correlated securities, collateral and other assets. The chart shows the complicated web of financial transfers, including transfers into and out of customer segregated accounts, in the days leading up to MF Global's bankruptcy, as liquidity demands on the firm intensified.

Figure B-2. Increased Margin Calls at MF Global



**Source:** February 6, 2012 status update from the Office of James Giddens, trustee for the liquidation of MF Global Inc. The chart shows how the demand for additional margin from MF Global to cover its own trading positions increased in the final days before the firm's bankruptcy.

**Figure B-3. Customer Funds in Segregation at MF Global: Excess Turns into Deficit**



**Source:** February 6, 2012 status update from the Office of James Giddens, trustee for the liquidation of MF Global Inc.

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