

The Collapse of MF Global: What Happened and Lessons Learned

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Futures market participants were caught off-guard when MF Global Inc., a commodity futures broker, filed for bankruptcy on October 31, 2011. Bankruptcies of financial firms are not unusual, so why did this one cause such consternation?

Essentially, this episode educated industry participants that customer protections in the U.S. commodity futures markets are more ambiguous than expected. That said, there are a number of reforms that could be undertaken to prevent future MF Globals.

This is a working paper version of an article that originally appeared in the September 2012 edition of FIRE [Finance, Insurance, and Real Estate] Policy News.

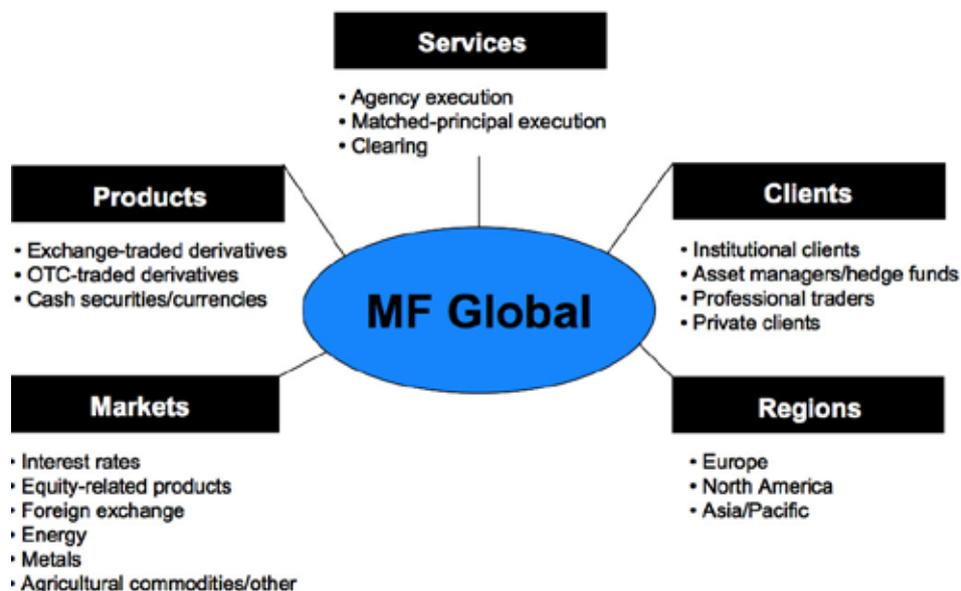
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Background

Before its bankruptcy filing, MF Global Holdings Ltd. provided "execution and clearing services for exchange-traded and OTC derivatives products, non-derivative foreign exchange products, and securities in the cash market," as described by a Bloomberg summary. Please see Figure 1.

Figure 1: MF Global's Lines of Business



Source: MF Global Ltd Form 10Q for the Quarterly Period Ended December 31, 2007, page 33.

"Although a niche player on Wall Street, MF Global was a force on the Chicago Mercantile Exchange. It had 3 million futures and options positions with a notional value of more than \$100 billion. Its customers made up 28 per cent of the trading volume on the CME," noted the *Financial Times*.

Warning Signs

Prior to the firm's spin-out from its parent company in 2007, MF Global's business could be characterised as "dull normal."

During the spin-out of MF Global (MFG), parent company Man Group burdened MF Global with (arguably) an enormous short-term debt load, relative to the firm's profitability. Please see Figure 2.

Figure 2: MF Global LTD. Notes to consolidated Financial Statements (Unaudited - Dollars in thousands, except share data)

Short-term borrowings consist of the following:

	December 31, 2007	March 31, 2007
364-Day Bridge Facility	\$ 1,400,000	\$ -
Other short-term borrowings	\$ 400,000	
Bank overdrafts	73,672	25,453
Current portion of long-term borrowings		58,552
Total	\$ 1,873,672	\$ 82,005

Source: Excerpted from MF Global Ltd. Form 10-Q as of December 31, 2007.

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. That said, MFG was eventually successful in doing so by the end of 2008.

MF Global's business model became in jeopardy during the compression of yields available in fixed-income investments. Please see Figure 3.

Figure 3: Summary of MF Global's Losses After Fiscal Year, 2007

(Dollars in millions)	YEAR ENDED MARCH 31,				
	2011	2010	2009	2008	2007
Net (loss)/ income attributable to MF Global Holdings Ltd.	\$ (81.20)	\$ (137.00)	\$ (49.10)	\$ (69.50)	\$ 188.00

Source: MF Global Holdings Ltd Form 10-K for the Fiscal Year Ended March 31, 2011, p. 36.

As a futures commission merchant (FCM), the firm had strongly relied on income from the investment of customer collateral for its profitability. An FCM is allowed to credit back to customers only a fraction of the income the FCM earns on customer collateral.

In 2010, MF Global hired Jon Corzine as its CEO. Corzine's background included a stint as CEO of investment banking and securities firm Goldman Sachs, four years as the governor of New Jersey, and a partial term as a U.S. Senator. In Congressional testimony in December 2011, a few weeks after MF Global went bankrupt, Corzine admitted that he "had little expertise or experience in ... [the] operational aspects of" MF Global.

The CEO's plan was to eventually convert the futures broker into an investment bank. Corzine devised a strategy to enter into a large-scale, leveraged, proprietary trade on five "peripheral" European bond markets in an apparent bid to assure the firm's profitability in the face of a challenging environment for its business model. Please see Figure 4.

Figure 4: Scale of MF Global's Sovereign Exposure Compared to Other Financial Institutions

Company	Stated Balance Sheet Exposure*	Exposure as a % of Q End Equity	Exposure as a % of Q End Assets	Quarterly VaR Average	VaR as a % of Q End Equity
MF Global (MF)	\$6.4 B	460.6%	13.9%	\$3.0 M	0.2%
Citigroup (C)	\$13.5 B	7.7%	0.7%	\$184 M	0.1%
Goldman Sachs (GS)	\$1.9 B	2.6%	0.2%	\$101 M	0.1%
Jefferies (JEF)	N/A	N/A	N/A	\$12.7 M	0.4%
JP Morgan (JPM)	\$14 B	7.7%	0.6%	\$94 M	0.1%
Morgan Stanley (MS)	\$2.0 B	3.4%	0.2%	\$145 M	0.2%

*as measured under a firm's internal approach

Source: Hughes Hubbard Et Reed LLP, Attorneys for James W. Giddens, Trustee for the SIPA Liquidation of MF Global Inc., "Trustee's First Interim Report for the Period October 31, 2011 through June 4, 2012," In re MF Global Inc., Debtor, United States Bankruptcy Court Southern District of New York, Case No. 11-2790 (MG) SIPA, p. 89.

The Final Week

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.

At that point, MF Global rapidly liquidated some of its European bond bet; attempted to meet additional margin calls that resulted from its ratings downgrade; and attempted to meet customer redemptions as clients left the firm en masse.

During hearings before a U.S. Senate committee in April 2012, Chicago Mercantile Exchange (CME) Executive Chairman Terrence Duffy pointed out that MF Global's bankruptcy trustee had "said that the company had a liquidity crisis, and their increases went from \$200 (million) to \$900 million on their margin calls. That money had to come from somewhere, and if there's a liquidity crisis, where was that money coming from?"

The answer was provided in the bankruptcy trustee's well-written report of June 4h, 2012: *The money came from futures customer accounts.*

By the early morning of October 31, 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 memorandum of March 2012.

A potential deal for another firm to buy MF Global Inc. collapsed, given the shortfall in customer segregated accounts.

Regulators' and Bankruptcy Trustee's Response

On October 31, MF Global's holding company declared bankruptcy under Chapter 11 of the Bankruptcy Code; and the Broker-Dealer/Futures Commission Merchant subsidiary was put into liquidation in a Securities Investors Protection Act (SIPA) proceeding.

The legal procedures, though, which cover the liquidation of securities firms, can potentially 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 Securities and Exchange Commission (SEC) as a broker-dealer *and* also by the Commodity Futures Trading Commission (CFTC) as a futures commission merchant.

The decision to put MF Global through a bankruptcy process that had been designed for securities firms "baffled futures industry participants who felt it would delay customers being made whole", explained *Futures Magazine*. "[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."

Futures customers of MF Global were caught flat-footed by the firm's 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.

Starting on October 31, 2011, MF Global customers' funds and futures positions were frozen on and off for days.

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," wrote two board members of the National Futures Association (NFA).

Stepping into the vacuum, two Chicago futures industry participants quickly created a grassroots organisation to represent the interests of futures customers in ongoing proceedings. This grassroots organisation is the Commodity Customer Coalition (CCC) and now includes over 10,000 customers of MF Global.

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, reported *Futures Magazine*. The SIPC trustee responsible for liquidating MF Global Inc. had to go through a "steep learning curve regarding futures operations," the industry publication noted.

In November 2011, the CME Group 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 the trustee had paid out more funds than he was entitled to do).

Thus far and after a number of delays, U.S. futures customers have received 80 per cent of their funds back.

Three Harmful Types of Transactions

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

According to a *Futures Magazine* summary of a March 2012 U.S. House of Representatives memorandum, 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."

The firm "violated the most basic obligation of any brokerage firm, which is to protect customers' assets," summarised the *New York Times*.

On June 4, 2012, the bankruptcy trustee report concluded:

"The actions of management and other employees, along with [the] lack of sufficient monitoring and systems, resulted in FCM customer property being used during the liquidity crisis to fund the extraordinary liquidity drains elsewhere in the business, including margin calls on the European sovereign debt positions."

Approximately \$700 million in additional customer funds are also at the centre of a dispute between U.S. and U.K. bankruptcy administrators in terms of which client pool has legal claim to these funds.

In April 2012, the U.S. bankruptcy trustee noted that he "believes that there are claims he may assert against certain responsible individuals [in MF Global's holding company and operating subsidiary] ... for, among other things, breach of fiduciary duties owed to both [the operating company] and its customers, and violations of the segregation requirements of the Commodity Exchange Act."

Legal and Congressional Aftermath

Also in April, the president of the NFA contacted the U.S. Attorney for the Northern District in Illinois in Chicago and offered "the assistance of the National Futures Association in the investigation of potential criminal conduct surrounding the collapse of MF Global Inc."

In addition, a U.S. Congressman, who is a member of the House Financial Services Committee, is encouraging the U.S. Justice Department to turn over its investigation of the MF Global Holdings Ltd. collapse to an independent counsel.

Lessons Learned

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] A governmental or self-regulatory body should receive direct reports from custodian banks that hold margins of futures customer, as is done in China;

[4] 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, as in Canada.

Reform Suggestions

Having learned from the chaotic aftermath of the MF Global collapse, the CCC supports the following reforms:

"Bar firms from housing their Broker-Dealer and FCM operations in the same entity; so when a firm fails, its Broker-Dealer entity goes through SIPC and its FCM goes through [a separate] Chapter 7 [liquidation proceeding.]

"If barring Broker-Dealer/FCMs is too sweeping or costly, create rules which automatically sweep excess futures margin into a SIPC insured account, so at least customers of Broker-Dealer/FCMs can have assets[,] which do not margin positions[,] insured by SIPC."

Conclusion

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

But clearly one hopes that the final narrative will be one where U.S. futures customers do eventually receive 100 per cent of their funds back, however this is achieved.

Endnotes

This article is excerpted from a presentation that the author gave to the Chicago chapter of the Professional Risk Managers' International Association (<http://www.prmia.org>) on June 15, 2012.

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