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Ask the Professor: "OMG! What Did MF Global Do?

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ASK THE PROFESSOR: "OMG! WHAT DID MF GLOBAL DO?"[1]

BY PROFESSOR RONALD FILLER[2]

MF Global Inc. ("MFG") was registered as a broker-dealer ("BD") with the U.S. Securities and Exchange Commission ("SEC") and as a futures commission merchant ("FCM") with the U.S. Commodity Futures Trading Commission ("CFTC"). In fact, it was one of the largest U.S. FCMs with approximately $7,270,000,000 in customer segregated funds as of August 31, 2011.[3] On or about Sunday, October 30, 2011, MFG reported to regulators[4] that a material shortfall appeared to exist in the amount of customer funds required to be segregated under the Commodity Exchange Act[5] and CFTC Regulation 1.20[6] promulgated thereunder.[7] Shortly thereafter, MFG's clearing privileges at several clearing houses were suspended and MFG was put on liquidation only trading status.[8]

James W. Giddens, the Bankruptcy Trustee appointed by the U.S. Bankruptcy Court, stated in the SIPC's Trustee Emergency Motion:

1. More than 150,000 customer accounts were frozen on October 31st;

2. Of this total, more than 50,000 accounts were trading futures contracts as of that date;

3. The Chicago Mercantile Exchange ("CME") estimated that MFG's customer segregated funds should total approximately $5.45 billion, and that the CME held approximately $4.0 billion in cash or collateral as of that date.

4. The Securities Investor Protection Corporation ("SIPC") filed an application under the Securities Investor Protection Act of 1970, as amended ("SIPA"),[9] for the entry of a protective order placing MFG in liquidation under SIPA as MFG could no longer comply with the requirements regarding financial responsibility under Section 15(c)(3) of the Securities Exchange Act of 1934 ("1934 Act")[10] and SEC Rules 15c3-3 and 17a-3.[11]

5. On October 31, 2011, the Honorable Paul Engelmayer, U.S. District Court for the Southern District of New York, entered an Order ("the MFG Liquidation Order") which commenced liquidation of MFG pursuant to SIPA in a case captioned as: *Securities Investor*

CONTINUED ON PAGE 3

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Protection Corp. v. MF Global Inc., Case No. 11-CIV-7750 (PAE).

6. The MFG Liquidation Order appointed James W. Giddens as Trustee for the liquidation of the business of MFG and appointed Hughes Hubbard & Reed LLP, as counsel to the Trustee.[12]

According to the SIPC Trustee's Emergency Motion, there appears to be a shortfall in the amount of customer funds required to be held in segregation pursuant to CEA Section 4d[13] and CFTC Regulation 1.20[14] According to numerous media reports, the amount of this shortfall has ranged between $900 million on the high end to $600 million on the low end. This paper will address what may have caused such shortfall and what actions may be pending.

Background

This author has written many articles recently on how futures customer funds must be held by an FCM, how the U.S. rules differ from similar customer fund rules in the U.K., and how initial margin is determined.[15] As noted in these articles, one of the most important customer protection themes underlying the CEA and CFTC regulations is the protection of customer assets, cash and collateral, held by an FCM to margin the customer's underlying futures contracts. These rules are sacrosanct. Unlike checking and stock accounts, which have insurance programs, funded by the U.S. government and industry firms, to protect customers of banks (e.g., FDIC Insurance) and customers holding stock accounts (e.g., SIPC Insurance), futures customers do not receive any special insurance proceeds if their FCM files for bankruptcy, like MFG did.

However, the applicable laws and regulations strictly govern how FCMs must properly fund the customer segregated accounts and significantly restrict how FCMs may invest the customer funds. For example, one important restriction is included in CFTC Regulation 1.25, which provides that an FCM may invest customer property in only certain permissible investments and holds the FCM liable for any losses that may result from such investments.[16]

Equally as important, upon deposit in a protected customer segregated account, customer funds must remain in such protected accounts until returned back to the customer. Therefore, whenever an FCM transfers funds to a derivatives clearing organization ("DCO"), commonly referred to as a clearing house or central counterparty, the funds held by a DCO must also comply with CFTC Regulation 1.20. Similarly, if a U.S. customer wants to trade futures on a non-U.S. futures exchange, the funds used to margin the non-U.S. futures positions must be held in another protected account, called a secured amount account under CFTC Regulation 30.7.[17] Thus, at all times, customer funds used to margin futures contracts are held in these protective accounts, solely for the benefit of the customers.[18]

Insolvency of an FCM

Whenever an FCM files for bankruptcy, and that FCM, like MFG, is jointly registered as both a BD and FCM, a SIPC Trustee is appointed. Thus, Mr. Giddens was appointed as the SIPC Trustee for MFG, just like he was when Lehman Brothers Inc. filed for bankruptcy in September 2008. However, although SIPA plays an important role with respect to any securities account held by customers of the BD/FCM, Part 190 of the CFTC Regulations provides key guidance with respect to the futures customer accounts held by the BD/FCM.[19]

An FCM's insolvency does not necessarily mean that futures customers will be adversely impacted by any loss of funds. For example, two very large FCMs, REFCO in 2005 and Lehman Brothers in 2008, both filed for bankruptcy protection without incurring any futures customer losses to the extent such funds were held in a protected customer segregated account. In fact, this author, who was a Managing Director in the Capital Markets Prime Services Division at Lehman Brothers before joining the faculty at New York Law School, was invited back to assist Lehman Brothers Inc. during that infamous week of September 15-19, 2008 to help move the underlying customer funds and open positions to other well-capitalized FCMs or liquidate the open

futures positions and return the margin property back to the respective customer. To say the least, it was an interesting and challenging week. The big difference between Lehman Brothers in September 2008 and MFG now is that the registered Lehman entity, Lehman Brothers Inc. ("LBI"), had not filed for bankruptcy on September 15, 2008, the day that its parent company, Lehman Brothers Holdings Inc, and other Lehman affiliates filed for bankruptcy. However, with respect to MFG, both its parent company, MF Global Holdings Inc., and MFG, the registered BD/FCM, both filed for bankruptcy protection the same day. This difference provided customers of LBI with important opportunities and flexibility to transfer and/or liquidate open positions under their own direction and control, and to transfer the underlying cash and collateral used to margin these open positions under their direction as well.

MFG's Bankruptcy

MFG filed for bankruptcy on Monday, October 31, 2011. While many of its customers may have moved their open positions and funds before that date, such transfers took place before the public was aware of its bankruptcy proceedings.[20] During this first week, much was reported by various media outlets but the full set of facts has not been made public, and will not be until all the various investigations now taking place by many parties, including the CFTC and the SEC, report their findings. However, Mr. Giddens did take some important actions through the Emergency Motion, providing important transfers of open positions and part of the underlying cash and collateral used to fund these open positions.

On November 2, 2011, Judge Martin Glenn of the U.S. Bankruptcy Court for the Southern District of New York, issued an Order granting the Emergency Motion requested by Mr. Giddens, among other things:

1. The Trustee may continue to operate MFG in the ordinary course until 6:00pm on Friday, November 4th;

2. The Trustee shall use his best efforts to complete the Account Transfers to one or more FCMs that have agreed to accept such open customer positions, together with up to 60% of the underlying customer property used to fund those open positions;[21]

3. The account transfers may not be avoided under Section 764(b) of the Bankruptcy Code; and

4. The Trustee shall not be held liable to any claims that may result with any such transfers.[22]

So, What Happened with MFG?

Like most players in the futures business, one can only speculate what actually happened that caused any shortfall in the customer funds held at MFG, if any shortfall does in fact exist. The truth and facts will soon be revealed. The following are only theories as to what might have happened. To be honest, given the excellent record of the futures industry protecting futures customer, this author, who has spent his past 35+ years defending this great industry, truly hopes that none of these theories prove to be true.

1. The press has reported that MFG lost substantial amounts betting on European bonds and sovereign debts. What has not been revealed is what MFG entity actually made these investments if, in fact, they were made and these investments resulted in substantial losses under our mark-to-the-market accounting method. Were these investments made by MFG, the registered BD/FCM, or by another MF Global entity? If the former, then MFG would most likely not have the requisite regulatory capital to continue to operate as a registered BD/FCM entity. This is the most likely scenario as Mr. Giddens in his Emergency Motion stated that MFG could no longer meet its requirements for financial responsibility but he provided little detail behind this statement. If, however, these so-called European bets were made in a different MF Global entity, and that MF Global entity was not guaranteed by MFG, then MFG could possibly continue to operate. Since this did not occur, and a SIPC Trustee was ap-

pointed, the former is presumably the most likely theory.

2. Even if MFG lost substantial amount of capital through these investments, or even through poor operating revenues, these facts should not have caused a shortfall in the customer segregated account. The U.S. regulatory system is designed to protect all non-defaulting customers of an FCM. Based on the facts known to date, no large futures customer at MFG traded in a manner that caused a large trading loss that caused MFG to file for bankruptcy. This is a key statement because applicable CEA and CFTC regulations were written in part from this perspective, that is, that a large futures customer could trade in such a manner that could result in the FCM's bankruptcy. In other words, such a large one-day trading loss exceeds the regulatory capital of the FCM resulting in its insolvency. Under this scenario, the clearing houses, pursuant to their rules, provides a systematic approach to stabilize the market and provide the necessary amounts to those customers who earned trading profits from these same trades under the zero-sum game model. These procedures include, among other things, the use of guaranty funds, the right to assess non-defaulting clearing members and even using funds of the non-defaulting customers of the bankrupt FCM clearing member. However, this situation did not occur with MFG. Therefore, any shortfall presumably did not result from futures trading. However, if MFG did in fact invest its own capital in the European bonds, and thus lost substantial amounts, one must ask whether MFG took the necessary deductions from such regulatory capital, as these investments must be marked-to-the market on an ongoing basis.

3. The key question, and one bothering this author the most, is whether MFG misappropriated customer funds held in the protected account, improperly invested such funds outside the permissible investments set forth in CFTC Rule 1.25 or did properly comply with CFTC Rule 1.25 but did not replenish the segregated accounts in a timely manner as these permissible investments lost money. CFTC Rule 1.25 permits investments in obligations of sovereign nations. It will be interesting to see what type of investments were made by MFG with respect to the customer segregated funds.

Following the transfer of open positions and a major portion of the cash and collateral held to margin these open positions on November 4th, other developments were noted by the SIPC Trustee, namely:

1. The SIPC Trustee had established procedures to transfer securities accounts held by MFG to other SIPC firms.

2. The SIPC Trustee has retained Ernst & Young as forensic accountants and Deloitte to assist in the account transfers and processing of claims.

3. The SIPC Trustee has established a website and call center to facilitate communications with customers and creditors of MFG. The website is: www.mfglobaltrustee.com

Also note that all of the major clearing houses have issued advisories regarding the transfers of open positions and collateral. You should go to their websites to view updates and related issues. We also need more information regarding what's happening with the transfer of open positions and collateral outside the U.S. as MFG's customer accounts traded futures globally. This may be the subject of a forthcoming article.

Conclusion

As noted above, for the sake of this industry, I truly hope that none of these theories prove to be true. But if they do, one can only presume that regulatory changes are brewing at a time when the industry is undergoing major regulatory changes as a result of the Dodd-Frank Act.[23] Query, do we really need any such regulatory changes just because one firm may have acted in an improper way?

NOTES

1 This article was written on November 8, 2011, to meet the publisher's deadline. Obviously, new events may have subsequently occurred that will impact many of the issues discussed herein.

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3 See Report on "Financial Data on Futures Commission Merchants", CFTC Website (www.cftc.gov). This report also showed that MFG had approximately $495,000,000 in "adjusted net capital", a defined term under CFTC Regulation 1.17 and had excess adjusted net capital of approximately $167,000,000, also as of August 31, 2011.

4 Presumably, the CFTC, the SEC, the National Futures Association ("NFA"), the Financial Industry Regulatory Agency ("FINRA") and certain securities and futures exchanges, such as the New York Stock Exchange ("NYSE") and the Chicago Mercantile Exchange ("CME"). The CME acted as the designated self-regulatory organization ("DSRO") for MFG in the futures industry.

5 7 U.S.C. 1 *et seq*.

6 17 C.F.R. § 1.20. CFTC Regulation 1.20 states: "All customer funds shall be separately accounted for and segregated as belonging to commodity or option customers. Such customer funds when deposited with any bank, trust company, clearing organization or another futures commission merchant shall be deposited under an account name which clearly identifies them as such and shows that they are segregated as required by the Act and this part."

7 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", filed on November 2, 1022 before the U.S. Bankruptcy Court for the Southern District of New York in *In Re MF Global Inc.*, Case No. 11-2790 (MG) SIPA. (hereinafter referred to as "SIPC Trustee's Emergency Motion).

8 *Ibid,* at page 2.

9 78aaa *et seq*.

10 15 U.S.C. §§ 78o(c)(3) and 78q(a).

11 17 C.F.R. §§ 240.15c3-3 and 240.15a-3.

12 *Supra,* note vi, at pages 2-3.

13 17. U.S.C. 6d.

14 *Supra,* note v.

15 See *Are Customer Funds Segregated/Secured Amount Funds Properly Protected after Lehman?,* Journal on the Law of Investment & Risk Management Products, The Futures & Derivatives Law Report (November 2008); *Ask the Professor—What is Margin and How Is It (Or Should be) Determined?,* Journal on the Investment & Risk Management Products, The Futures & Derivatives Law Report (March 2009); and *Consumer protection: How U.K. Client Money Rules Differ From U.S. Customer Segregated Rules When a Custodian Firm Fails to Treat Customer Funds Properly,* Journal of Taxation and Regulation of Financial Institutions (May/June 2011).

16 17 C.F.R. 1.25. Please note that the CFTC has proposed changes to the provisions of CFTC Rule 1.25. If adopted as proposed, the types of permissible investments and the amount of investment in such permissible investments will be significantly changed from the current environment.

17 17 C.F.R. 30.7.

18 CFTC Regulation 1.20 also requires an FCM to receive an acknowledgement letter from the custodian bank or other depository that may hold futures customer assets which confirms that the custodian bank or depository may not apply any of the assets held in the protected customer account to satisfy any obligations owed by the FCM to the custodian bank.

19 See Part 190 of the CFTC Regulations, 17 C.F.R. 190 *et seq.*

20 According to the SPIC's Trustee Emergency Motion, the CME estimated that the amount held in customer segregated funds totaled approximately $5.45 billion as of October 31, 2011, whereas the CFTC reported that MFG held approximately $7.27 billion as of August 31, 2011, a decrease of over $1.8 billion in the past two months.

21 As it turns out, six different FCMs accepted the transfer of open futures positions held on the books of MFG by Friday, November 4th. This involved the transfer of approximately 15,000 futures customers and approximately $1.45 billion in cash and collateral from the CME. Other clearing houses and exchanges cooperated as well and made similar transfers.

22 See "Order Granting 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, November 2, 2011.

23 Dodd-Frank Wall Street Reform and Consumer Protection Act, P.L. 111-203, 124 Stat. 1376 (2010).