Testimony on The Collapse of MF Global: Lessons Learned and Policy Implications

by Robert Cook
Director, Division of Trading and Markets
U.S. Securities and Exchange Commission

Before the
Committee on Banking, Housing, and Urban Affairs
United States Senate

Tuesday, April 24, 2012

Chairman Johnson, Ranking Member Shelby, members of the Committee:

My name is Robert Cook, and I am the Director of the Division of Trading and Markets at the Securities and Exchange Commission ("SEC"). Thank you for the opportunity to testify on behalf of the SEC concerning the collapse of MF Global.

The bankruptcy of MF Global has resulted in serious hardship for many of its customers, who have experienced significant delays and uncertainty with respect to their ability to access their own assets. More broadly, the firm's collapse and the apparent shortfall in customer assets highlight the need for financial firms and regulators to remain vigilant in ensuring that customer assets are appropriately protected and made readily available to customers whenever they may be needed.

To that end, the SEC and its staff are working with the trustee, our fellow financial regulators, and other authorities to facilitate the orderly liquidation of MF Global and the return of MF Global customer assets. While the examination and review of the causes and implications of the collapse of MF Global are ongoing, my testimony provides an overview of the regulation of MF Global's SEC-registered broker-dealer subsidiary prior to the bankruptcy, the key events leading up to the bankruptcy, the status of approximately 318 securities accounts in the liquidation proceedings, and the securities customer protection regime. My testimony also describes some implications of MF Global's bankruptcy for market oversight, as well as a summary of recent efforts by the SEC to promote sharing of information among regulators, a proposal by the SEC to further strengthen the rules that affect the protection of customer assets, and self-regulatory organization ("SRO") initiatives to enhance the financial responsibility regime for broker-dealers.

Regulation of MF Global Prior to its Bankruptcy

MF Global Holdings Ltd. (together with its subsidiaries, "MF Global") was a publicly traded holding company that conducted financial activities through a number of subsidiaries located in various countries. MF Global Inc. ("MFGI"), an indirect subsidiary of the holding company, was dually registered with the Commodity Futures Trading Commission ("CFTC") as a futures commission merchant ("FCM") and with the SEC as a broker-dealer. As of October

31, 2011, MFGI had approximately 36,000 futures customers[1] and approximately 318 custodial accounts for non-affiliated securities customers.[2] MFGI also was authorized by the Federal Reserve Bank of New York to act as a primary dealer in the U.S. Treasury markets. Another affiliate, MF Global UK Limited, was regulated by the U.K. Financial Services Authority ("FSA"). There was no consolidated supervisor of MF Global at the holding company level.

The "front-line" supervisory function for the securities activities of broker-dealers is performed by the SROs, including the Financial Industry Regulatory Authority ("FINRA") and the various securities exchanges. When a broker-dealer is a member of multiple SROs, one SRO functions as the "designated examining authority" ("DEA") responsible in the first instance for examining the securities component of the firm's financial and operational programs, including its compliance with the SEC's capital and customer protection requirements. In the case of MFGI, the DEA was the Chicago Board Options Exchange ("CBOE"), although FINRA was also closely involved in the oversight of MFGI's broker-dealer activities. The futures activities of financial firms, including related segregation requirements, are overseen by the CFTC and the futures SROs, including the National Futures Association and the Chicago Mercantile Exchange.

The SEC oversees the regulatory functions of securities SROs and regularly communicates and coordinates with them on examinations and other matters. In its SRO role, CBOE conducted examinations of MFGI for compliance with financial responsibility rules. FINRA conducted examinations for compliance with other rules, such as sales practice requirements. In addition, the SEC's national examination program conducts its own risk-based examinations of SEC-registered broker-dealers. Unlike some other regulators of financial firms, the SEC does not have an "on site" presence at any broker-dealer and generally does not have examination staff dedicated solely to particular broker-dealers.

Key Events Leading Up to the Bankruptcy

Although the investigation of the causes of MFGI's collapse is ongoing, we can highlight our current understanding of several key events leading up to its failure.[3]

---

[1] See Expedited Motion to Approve Further Transactions and Distributions for MF Global Inc. United States Commodity Futures Customers (Nov. 29, 2011).

[2] In his motion seeking authorization to sell and transfer substantially all customer securities accounts held by MFGI, the trustee identified approximately 330 securities accounts that were custodial accounts that had positive net equity on October 31, 2011, excluding accounts of affiliates and firm insiders. See Motion of James W. Giddens, Trustee for the Liquidation of MF Global Inc., for an Order Authorizing the Sale, Transfer, and Assignment of Certain Customer Securities Accounts (Nov. 30, 2011) ("Trustee Securities Account Transfer Motion"). A subsequent status update filed by the trustee with the U.S. Bankruptcy Court for the Southern District of New York indicated that the court's order applied to the sale and transfer of "approximately 318 active retail securities accounts." See Trustee's Preliminary Report on Status of his Investigation and Interim Status Report on Claims Process and Account Transfers (Feb. 6, 2012) ("Trustee Interim Status Report").

[3] The events described in this testimony, other than those that are a matter of public record, are based on SEC staff's current recollection and information, including information from third parties that is currently unconfirmed. SEC staff's knowledge of the facts surrounding the bankruptcy of MF Global continues to develop, and accordingly the description of events herein is subject to change.

Capital Treatment of Repo-to-Maturity Transactions

During 2010, MFGI started acquiring significant proprietary positions in European sovereign debt, which were financed using an instrument called a "repo-to-maturity" ("RTM").[4] As of March 31, 2011, MFGI had accumulated several billion dollars of European sovereign debt positions using RTM transactions.[5]

In the summer of 2011, based on an analysis of MFGI's financial statements, FINRA and CBOE staffs questioned MFGI about whether the firm was properly recognizing its RTM positions for purposes of its regulatory net capital computations. The SEC's net capital rules (which are similar to those of the CFTC in important respects) require broker-dealers, including MFGI, to maintain certain minimum amounts of liquid capital based on their business activities. After consulting with SEC staff, SRO staff informed MFGI that under the SEC's rules it must take capital charges for the European sovereign positions as if they were on the firm's balance sheet, notwithstanding the fact that the bonds had been "sold" pursuant to the RTM transactions.

In August 2011, representatives of MFGI contacted SEC staff in Washington, D.C., to request a meeting to present the firm's view that the RTM positions should be subject to lesser capital charges than those determined by staff from the SROs and SEC. On August 15, 2011, SEC staff met with representatives of MF Global, including its Chief Executive Officer, Jon S. Corzine, to discuss this issue. After further consultations among the regulators, FINRA staff informed MFGI on or around August 24 that the regulators' collective view that a capital charge was required for the RTM positions had not changed.

Following the resolution of that issue, the regulators also discussed with MFGI: (1) whether MFGI needed to provide a formal net capital deficiency notice under SEC Rule 17a-11, which generally requires broker-dealers to provide a "hindsight notice" of any deficiency in their compliance with the SEC's financial responsibility rules; and (2) whether MFGI needed to restate and refile its monthly "FOCUS" report (containing capital and certain other financial information) for July 2011, which could result in the net capital deficiency becoming public.[6] Pursuant to Rule 17a-11, once the deficiency was identified, the firm was required to file the "hindsight notice" and, on August 25, it did so. After consulting with SEC staff, SRO staff also required the firm to file an amended FOCUS report for July 2011. On August 31, MFGI amended its FOCUS report for July 2011 to reflect the required capital charges, reporting a "hindsight" capital deficiency of approximately $150 million as of July 31, 2011. At the holding company level, MF Global disclosed the net capital issue regarding the RTM positions at MFGI

[4] An RTM is a form of a repurchase agreement. A repurchase agreement generally involves the sale of securities – here, European sovereign bonds – coupled with an agreement to repurchase the securities at a later date at a fixed price. In an RTM transaction, the repurchase date is the same date as the maturity date for the securities that were sold.

[5] See MF Global Inc., Financial and Operational Combined Uniform Single ("FOCUS") Report: Information Required of All Brokers and Dealers Pursuant to Rule 17a-5, Part III (Form X-17A-5 Part III) (Mar. 31, 2011), Statement of Financial Condition , Note 4.

[6] FOCUS reports are filed by broker-dealers with their DEA pursuant to SEC Rule 17a-5.

in an amendment to MF Global's public filings on September 1.[7]

Bankruptcy of MF Global

During the week of October 17, 2011, press reports noted that regulators had directed MF Global to increase capital at MFGI due to concerns about MFGI's capital treatment of its RTM positions. On Tuesday, October 25, 2011, MF Global announced quarterly earnings, reporting a net loss of $192 million for the three months ending September 30, 2011. Its stock price declined almost 50 percent that day and continued to decline over the week. During this same week, certain credit rating agencies downgraded the firm's credit rating or put it on negative watch. MF Global informed SEC staff during this week that certain counterparties and customers were reducing their exposures to MFGI, and MFGI was undertaking significant efforts to reduce the size of its balance sheet.

SEC staff commenced a continuous on-site presence at MFGI's New York office beginning on October 27 to monitor the firm's condition, and to engage with senior management regarding the steps that were being taken by the firm. On Friday, October 28, MF Global management reported on developments to Chairman Mary Schapiro and SEC staff, including myself. According to the firm, it was in discussions with various parties regarding potential strategic transactions, such as the sale of the firm, the sale of the RTM positions, and the sale of the firm's customer business. We continued to receive updates from our on-site staff and from calls with firm management on Saturday and Sunday, and we continued to consult closely with other regulators, including the CFTC, FINRA and the FSA. By Sunday afternoon, MF Global reported that the firm was close to concluding a strategic transaction with a potential purchaser of the customer business of MFGI, which could provide customers with continued access to their accounts. SEC staff worked closely with the CFTC and FSA to review and comment on the key transaction terms to determine that they provided adequate customer protection. However, MF Global subsequently reported in the early morning hours of Monday, October 31, that MFGI had identified a significant deficiency in its segregated accounts for futures customers, and that the acquisition negotiations had terminated.

At that point, after considering MFGI's financial condition and available alternatives, SEC staff determined, in consultation with the CFTC, that the safest and most prudent course of action to protect customer accounts and assets was to initiate a liquidation proceeding under the Securities Investor Protection Act ("SIPA").[8] A referral was made to the Securities Investor Protection Corporation ("SIPC") early in the morning on Monday, October 31. On that same day, the U.S. District Court for the Southern District of New York entered an order granting the application of SIPC to commence a liquidation of MFGI under SIPA and appointing James W. Giddens as trustee for the liquidation. The case was then removed to the U.S. Bankruptcy Court for the Southern District of New York ("Bankruptcy Court"). Also on October 31, MF Global Holdings Ltd. separately filed a voluntary bankruptcy petition in the Bankruptcy Court, and MF Global U.K. Limited entered administration proceedings in the United Kingdom.

---

[7] See MF Global Holdings Ltd., Amendment No. 1 to the Quarterly Report for the Period Ended June 30, 2011 (Form 10Q/A) (Sept. 1, 2011).

[8] SEC-CFTC Statement on MF Global, Oct. 31, 2011, available at http://sec.gov/news/press/2011/2011-230.htm.

MFGI Liquidation and the Impact on Securities Customers

The preferred method of returning securities customer assets in a SIPA liquidation generally is to transfer those assets in bulk to another solvent broker-dealer. This approach typically provides customers with access to their securities and funds more quickly than the claims process. Accordingly, shortly after the initiation of the SIPA proceeding, the trustee solicited from other broker-dealers interest in taking over MFGI's securities customer accounts. Based on the available expressions of interest, on November 30, 2011, the trustee filed an expedited motion seeking authorization to sell and transfer substantially all securities custody accounts to another broker-dealer. This sale and transfer applied to approximately 318 accounts held for non-affiliated securities customers of MFGI. The transaction was approved by the Bankruptcy Court on December 9, 2011.

Securities customers are able to trade their securities and use their funds upon completion of the transfer of their accounts. Moreover, each customer is given the option of maintaining the customer's securities account at the receiving broker-dealer or moving the account to a different broker-dealer selected by the customer. According to the trustee, of all former MFGI securities customers, nearly all have received 60 percent or more of their account value, and 194 have received the entirety of their account balances, after giving effect to the protection afforded by SIPC (up to $500,000).[9] Customers who do not ultimately receive 100 percent of their net equity through this initial transfer may be able to receive additional funds, up to the aggregate amount of their net equity, if the trustee determines that there is customer property available for that purpose. Although the claims submission deadline was January 31, 2012, for former MFGI commodities customers and former MFGI securities customers seeking the maximum protection under SIPA, securities customers and all general claimants may still submit claims to the trustee through June 2, 2012.

Throughout this process, SEC staff has been working closely with the trustee and SIPC, seeking to expedite the return of assets to customers of MFGI. To that end, SEC staff has been in frequent communication with the trustee with respect to the status of the transfers and claims made by securities customers.

Securities Customer Protection Regime

MFGI acted as a "carrying" firm for a small number of securities customers, meaning that it held their funds and securities. MFGI also had additional securities customers for which it executed purchases and sales of securities but did not hold funds and securities – rather, such securities were held at other custodians that settled transactions executed through MFGI on a "delivery versus payment" basis.

As a broker-dealer registered with the SEC, MFGI was subject to the SEC's customer protection rule. This rule requires that each broker-dealer that holds securities or cash for customers take two primary steps to safeguard customer property. These steps are designed to protect customer property by prohibiting broker-dealers from using customer funds and

[9] See Trustee Interim Status Report, supra note 2.

securities to support their proprietary positions or expenses. Together with the applicable SEC capital requirements, this regime also is meant to make it more likely that, if the broker-dealer fails, segregated securities and funds will be readily available to be returned to the customers.

The first step required under the customer protection rule is that the broker-dealer must maintain physical possession or control over securities that customers have paid for in full. This means that if a customer has fully paid for his or her securities, they cannot be used by the broker-dealer in its business – for example, they cannot be pledged as collateral to finance the firm's own trades or to raise funds for the firm to invest. Further, if a customer has a margin loan, the customer protection rule strictly limits the amount of securities that can be used by the broker-dealer for financing purposes. The goal in both cases is to require broker-dealers to hold customer securities in a manner that allows those securities to be readily available to customers, either on demand or upon the liquidation of the firm.

The second step required under the customer protection rule is that the broker-dealer must maintain a reserve in an account at a bank for the benefit of customers in an amount that exceeds the net funds attributable to customer positions. These funds cannot be invested in any instrument that is not guaranteed, as to principal and interest, by the full faith and credit of the U.S. government. The amount owed to customers must be computed pursuant to a prescribed formula, normally on a weekly basis. A broker-dealer cannot make a withdrawal from the reserve account until the next computation, and then only if the computation indicates that there is an excess amount in reserve – greater than what is required to be maintained under the rule. In essence, this requirement complements the protection afforded to <u>securities</u> held at a broker-dealer by requiring the firm to maintain a reserve of funds or U.S. government guaranteed securities equal to its net <u>cash</u> obligations attributable to customer positions.

A broker-dealer that complies with the customer protection rule – isolating customer funds and securities through these steps and separating them from the firm's proprietary business – should be in a position to return all the securities and funds it owes to customers if it falls into financial difficulty. If a broker-dealer cannot return all the securities and funds owed to customers, SIPC has the responsibility to institute a proceeding under SIPA to liquidate the broker-dealer. Under SIPA, all securities customers share *pro rata* in the available securities customer property before any other types of creditors of the broker-dealer. If the available securities customer property is insufficient to return 100 percent of the amount owed to securities customers, SIPC may advance up to $500,000 per customer (of which $250,000 can be used to make up a cash shortfall).

Implications for Market Oversight

While our near term focus has been on working with SIPC and the trustee to facilitate the return of securities and funds to customers of MFGI, the SEC will continue to strive to identify further enhancements to its customer protection regime that may be appropriate.

The events leading up to the bankruptcy of MF Global and its aftermath reinforce the importance of close and ongoing coordination and information sharing among regulators and other interested parties. In this case, these parties included not only the SEC and CFTC and

other federal regulators, but also the SROs, the FSA, SIPC and, following the bankruptcy filing, the trustee.

Protection of Customer Assets

While our experience with addressing MF Global's failure highlights the importance of domestic and international regulatory coordination, it also underscores the paramount importance of the rules governing protection of customer assets and the controls that are crucial for compliance with those rules. In general, the rules governing protection of customer funds and securities that apply to registered broker-dealers, described above, have worked well over time, but we are considering whether there are ways that they could be strengthened. In particular, in June 2011, the SEC proposed rule changes that are meant to clarify and strengthen the rules governing audits of broker-dealers, including an auditor's examination of broker-dealer controls relating to the custody of customer assets, as well as to enhance the SEC's oversight of broker-dealers that hold customer securities and funds. Specifically, the proposal would:

- Enhance the current requirement that a broker-dealer undergo an annual audit by a public accounting firm registered with the Public Company Accounting Oversight Board by strengthening the standards that govern the auditor's examination of the broker-dealer's compliance, and internal controls over compliance, with SEC net capital and custody requirements.
- Require that broker-dealers that maintain custody of customer assets file with the SEC a new "Form Custody" every quarter. This form would contain more detailed information about how broker-dealers maintain custody of customer assets in order to further facilitate verification by examiners that customer assets are being properly protected.

SEC staff has evaluated comments received in response to this proposal and is working to finalize a recommendation to the Commission.

More broadly, the staff is evaluating other possible rule changes to the financial responsibility requirements, including some previously considered by the Commission that could strengthen customer protection. For example, one change under consideration would be to limit, for purposes of the customer reserve fund required by Rule 15c3-3, the amount of cash a broker-dealer could maintain in any one bank, as a percentage of capital of the broker-dealer or the bank.

The SEC also continues to work with the SROs to help strengthen broker-dealer financial responsibility requirements. For example, in June 2011, the SEC approved a FINRA rule filing to establish registration, qualification, examination, and continuing education requirements for certain operations – or "back office" – personnel, including those who handle customer assets. This rule should help to better ensure that those responsible for operations functions are fully versed in all the relevant rules and their obligations, including those relating to the segregation and protection of customer assets. In addition, in February 2012, the SEC approved a FINRA proposal to require each member firm to file certain additional financial or operational schedules or reports to supplement existing requirements to file FOCUS reports with FINRA pursuant to SEC Rule 17a-5. This rule allows FINRA to receive more granular data pertinent to income and

expense items, and therefore to better identify firms that warrant heightened scrutiny and to evaluate industry-wide trends.

In February of this year, the SIPC Modernization Task Force, which was established by SIPC for the purpose of undertaking a comprehensive review of its operations and policies and to propose reforms to modernize SIPA and SIPC, issued a number of recommendations, including proposed statutory changes. SEC staff is evaluating these recommendations, several of which are directed to the scope and dollar limit of protection for individual customers in SIPC liquidations. Although SIPC has not itself yet responded to the recommendations, we look forward to discussing them with SIPC as part of our review.

Finally, with regard to accounting standards, in March 2012, the Chairman of the Financial Accounting Standards Board ("FASB") added a project to the FASB's agenda to reconsider the accounting and disclosure requirements for repurchase agreements and similar transactions. The FASB Chairman cited the need to revisit the accounting requirements to address application issues as a result of changes in the marketplace and to ensure that investors obtain useful information about these transactions. As part of the project, the FASB is expected to reconsider the accounting and disclosures requirements related to RTM transactions. There is ongoing communication between SEC staff and the FASB regarding their standard-setting efforts.

Regulatory Cooperation

Given the pace of developments in the financial markets generally and, in particular, how quickly the financial condition of a financial firm that is in distress can deteriorate, the SEC is engaged in a number of efforts – both domestic and international – to share more and better data and qualitative assessments of firms and markets, and to do so in a timely way. Some of these efforts involve coordination with the SROs, in recognition of their importance as "front-line" supervisors.

For example, examination staff in the SEC's Office of Compliance Inspections and Examinations ("OCIE") recently initiated quarterly meetings with FINRA and CBOE and semi-annual meetings with the Chicago Stock Exchange ("CHX"), in each case in respect of the SRO's capacity as a DEA. Further, OCIE recently has sought to enhance its inter-regulator Summit of Securities Regulators, increasing the frequency with which it convenes and expanding the group of regulators such that it now includes FINRA, CBOE, CHX, the Municipal Securities Rulemaking Board, the North American Securities Administrators Association, the Federal Reserve Board, various Federal Reserve Banks, and the CFTC. The first meeting of the expanded group will take place this month and will provide an opportunity for this diverse gathering of regulators to discuss issues and concerns regarding registrants, current regulatory developments, and to identify common risks and collaboration opportunities. In addition to these recent initiatives, the Commission has been a key participant in the Intermarket Surveillance Group ("ISG") since its formation in the 1980s. The ISG provides a critical venue for sharing investigative information and surveillance data among domestic and foreign market centers, market regulators, and exchanges, including both securities and futures exchanges.

For many years, the SEC has been engaged in numerous and ongoing efforts to increase cooperation and the flow of information relevant to market oversight among international regulators, through various means, including cooperative arrangements, such as memoranda of understanding ("MOU"), informal and formal bilateral discussions, and participation in multilateral organizations.[10]

In the international sphere, the SEC works closely with both banking and securities regulators through various venues, including the Financial Stability Board, IOSCO, the Council of Securities Regulators of the Americas, the Cross-border Crisis Management Working Group, and the Senior Supervisors Group. The SEC also has ongoing bilateral dialogues with key international regulatory counterparts, including the United Kingdom, India, China, Korea and Turkey. Furthermore, the SEC participates alongside the Department of the Treasury and the Federal Reserve Board in the Financial Markets Regulatory Dialogue with the European Union.

Conclusion

The SEC and its staff are working with our fellow financial regulators and other authorities to facilitate the identification and return of customer assets. We also are engaged in ongoing efforts to increase the exchange among regulators of information that is relevant to oversight of markets and market intermediaries, and are considering measures to further strengthen the existing customer protection regime.

I would be pleased to answer any questions you may have.

[10] A list of supervisory MOUs is available at: http://www.sec.gov/about/offices/oia/oia_cooparrangements.shtml.