



WHITE PAPER:
Background, Impacts & Solutions to MF Global's Demise

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Summary:

The failure of MF Global has wide ranging consequences for the American economy and its bankruptcy is being handled in a manner that is making these consequences much worse than they need to be. The freezing of customer segregated funds is having a chilling effect on global financial markets. It also has a less obvious but significant impact on the day-to-day operations of farmers, mining operators, ranchers, and other commodity consumers and producers.

The failure of MF Global directly contributed to the loss of approximately 2,800 jobs or more during this period of already high unemployment. But, the unnecessarily slow speed of this bankruptcy process will cause the loss of even more jobs as it directly damages other brokerage firms, investment advisors, and commodity consumers and producers. In fact, the *only* person served by the current bankruptcy process is the Trustee who has already submitted bills to the MF Global estate at \$891/hour for his time and an average of approximately \$500/hour for his staff. This is the same Trustee that spent 3 years working on the Lehman bankruptcy and billed the estate over \$160 million dollars despite not returning any customer funds.

If this bankruptcy is managed the same way as Lehman's, it will be the end of the United States as a viable jurisdiction for commodity trading. Congress should use whatever power it has to prevent this from happening.

What MF Global Was:

MF Global, Inc. was a commodities and securities brokerage firm dealing primarily in commodity contracts responsible for holding clients' cash and collateral.

Who MF Global Clients Are:

They represent a cross-section of people across America and the world, from farmers and ranchers who hedge their crops and herds, to oil producers and miners who use futures to lock-in prices and take delivery of physical commodities, to retirees who invest in futures to diversify their portfolios. For example, farmers who have crops in the field need to sell futures in commodity markets so they can lock in prices for their future yields today, instead of taking on market risk as they would otherwise be exposed to volatile price swings. Large corporations like Coca-Cola who make money in foreign markets do not want to lose money when they repatriate revenue earned in foreign currency. They have to be able to forecast future expenses and profits accurately in the currency of their domicile and hedge that currency price risk in futures markets accordingly. Speculators add volume and liquidity to these markets which allow for better, more efficient pricing of commodities. This allows for stability in prices of commodities and predictability of future profit and loss,

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which in turn allows for stability in producer and consumer prices. These commodities include everything from grains like corn and wheat, to energy like oil and natural gas, to softs like cotton and sugar, to currencies like the US dollar and Euro, to financial instruments like bonds and stock indexes. Simply put, trading in commodity futures markets is one of the backbones of the American economic engine.

Circumstances Surrounding the Bankruptcy:

MF Global was a 230 year old firm that principally acted as a clearing broker for commodities trades. Jon Corzine took over as CEO of MF Global in March 2010 with the intent of turning MF Global into an investment bank that makes bets with the firm's own capital. FINRA (the securities self-regulatory organization) gave Corzine a waiver, after he had not been in the industry for 12 years, which allowed him to be the head of MF Global without a license-- a license that every other person in the industry *must* have to even speak one word to a client. Since commodity brokers make most of their money on interest earned by holding customers' collateral for trading, the low interest rate environment since the financial crisis of 2008 has been tough on many brokers. This has lead some like MF Global to seek higher yields using more aggressive strategies. Corzine took on too much risk in seeking greater yields and on October 25, 2011 MF Global reported a large quarterly loss due to a 40:1 leveraged exposure to European sovereign debt. Fears over this leveraged exposure crushed MF Global's stock, caused its bonds to trade at distressed levels and led it to max out company lines of credit. MF Global sought Chapter 11 bankruptcy protection on October 31, 2011 after an acquisition by Interactive Brokers fell through. The acquisition collapsed because of a discrepancy of \$633 million dollars in customer funds (out of a total of \$5.45B, or 11.6%) that were supposed to be fully segregated from the firm's capital but could not be immediately accounted for.

Segregated Funds- Cornerstone of the Commodities Industry:

One of the big differences between commodities brokers and securities (stocks and bonds) brokers is that commodity brokers have an obligation to keep customer funds *completely* segregated from the firm's own assets. This is to ensure that clients are completely protected from losses sustained by the firms' trading and operations. Many industry groups and regulators have loudly heralded the fact that because of this segregated account protection, no client has ever lost a penny from a segregated account as the result of a broker bankruptcy. So whereas securities clients are afforded various insurance in the event of a broker bankruptcy, commodities clients are afforded none since their funds cannot be comingled with a broker's assets and cannot be used to pay creditors in a bankruptcy. Segregated funds are accounted for daily to the National Futures Association (NFA) and to the Commodity Futures Trading Commission (CFTC) through the broker's designated self-regulatory organization (DSRO), which in MF Global's case was the Chicago Mercantile Exchange (CME).

Compromise of the Segregated Accounts System

Industry groups and regulators argue that the commodities trading industry is able to function with lighter regulations than securities trading because customer accounts are segregated from firm assets. However, in the MF Global case, there is \$633M in these segregated client funds that are unaccounted for, either due to sloppy accounting or nefarious activity

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conducted by the firm. This has resulted in a compromise of the integrity of the segregated accounts system, and a complication of the bankruptcy proceeding by involving a number of parties with little to no experience in commodities.

The Bankruptcy Process and its Flaws

The bankruptcy process has been delegated to SIPC, the securities insurance regulator, after it petitioned the bankruptcy court to begin a liquidation proceeding of MF Global's broker-dealer. SIPC stands for "Securities Investor Protection Corporation." It was created by the Securities Investment Protection Act of 1970 and was designed to protect owners of securities in a similar way to how the FDIC protects bank depositors. However, the vast majority of customer assets affected by this bankruptcy are NOT securities, rather they are cash and commodity futures contracts, and SIPC's attorneys have limited experience with commodity futures contracts. Despite the fact that about 11.6% of the segregated funds have yet to be accounted for, 88.4% have been. There is no reason, whatsoever, that these funds should not be *immediately* released to their rightful owners.

The Trustee intends to put these segregated funds through the same claims process common to securities assets in bankruptcy. If that happens, the process will take months to reach fruition, perhaps years which is unprecedented in the commodities industry. The most recent bankruptcy of a major commodities clearing firm, Refco, Inc., involved no freezing of assets and no cessation of trading for any customer.

There is no discernible reason to put commodity futures customers of MF Global through such a process, when the rightful owners are already known and 88.4% of the funds are accounted for. During this convoluted claims process, the Trustee will continue to amass millions of dollars in administrative fees which will further deplete customer segregated funds. If customers do not have additional collateral to post for trading purposes, they too will face bankruptcy as they are unable to do business. For example, farmers whose collateral is locked up may have to sell their land and equipment to post new collateral so they can hedge their crops or face financial ruin through exposure to volatile price swings in the market. While this collateral is locked up, those price swings will become worse as volume dries up in smaller markets-- which is already happening:

<http://online.wsj.com/article/SB10001424052970204190704577026421744881052.html?KEYWORDS=MF+Global>

Even worse, the Trustee is already putting it out in the media that customers of MF Global may have to share in the loss of segregated funds pro-rata with other creditors. By subordinating customers with collateral in segregated funds to creditors of MF Global's estate, the Trustee is essentially making the creditors the beneficiary of a criminal act. If MF Global comingled segregated funds with corporate assets, it was a criminal act. Paying such a creditor's claim with a portion of those comingled funds would make them a beneficiary of that crime. Paying JP Morgan with an Iowa farmer's money is not only morally and legally wrong, it risks the future of the American economic model. Who would want to hold a commodities account in the United States ever again? Considering the MF Global's clients have no representation on the creditors committee, but the big banks do (like JP Morgan and Bank of America), that is exactly what will happen without intervention.

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Solutions

Congress needs to use all means at its disposal to affect change in the process underway to return MF Global's clients assets as quickly as is possible. Additionally, Congress needs to examine the culpable players involved in this quagmire (Corzine, James Giddens, CFTC, CME, NFA, etc.) and shed some light on how their actions are affecting your constituents. We believe the following to be potential solutions to the problem:

Short-Term

- Order Trustee to release 88.4% of client assets to their rightful owners *immediately* to prevent further damages, bankruptcies and loss of business for MF Global clients. The remaining 11.6% can go through the claims process, so long as it is understood that these assets must be returned as quickly as possible;
- Align incentives for the Trustee with clients' to ensure a speedy distribution of the remainder of assets. This can be done by limiting the Trustee to a flat fee or a fixed percentage of the assets of the estate (NOT the customer segregated funds);
- Assign a representative for MF Global clients to the creditor's committee to ensure customers have an advocate alongside major creditors like JP Morgan and Bank of America;
- Demand the Chicago Mercantile Exchange setup a temporary fund of \$633M so clients can be paid out immediately, then take over on clients' behalves in bankruptcy court and/or assess a special fee to all trades that executed on the CME to repay the fund.

Long-Term

- Regulate leverage used by brokerage firms on a daily basis, rather than on one specific day in a quarter (earnings);
- Limit brokerage firms' investment of customer segregated funds to US treasury securities;
- Impose severe criminal penalties for any officer or director of a publicly traded financial institution who commingles client segregated funds with firm assets.

Please contact either John Roe or James Koutoulas for references or additional information.

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