

## **I. MF Global**

### **A. Introduction**

Following the financial crisis of 2008, Congress enacted the Dodd-Frank Wall Street Reform and Consumer Protection Act (“Dodd-Frank Act”) “to promote the financial stability of the United States by improving accountability and transparency in the financial system, . . . to protect consumers from abusive financial services practices, and for other purposes.”<sup>1</sup> On October 31, 2011, MF Global, a broker-dealer and futures commission merchant, filed for bankruptcy after excessive exposure to European sovereign debt rendered it unable to obtain financing. This article will look at how accounting loopholes helped MF Global mask its leverage and risk exposure, resulting in the possible use of customer funds to meet liquidity needs, and consider whether the Dodd-Frank Act addresses these concerns and could have prevented or warned of MF Global’s demise. Part B provides background information on MF Global, particularly the changes induced by John Corzine following his appointment as CEO in 2010. Part C looks at the two identified problems in the context of the regulatory structure in existence at the time of MF Global’s filing for bankruptcy. Part D considers whether the Dodd-Frank Act will forewarn of or prevent bankruptcies similar to MF Global’s in the future.

### **B. Lead Up to Bankruptcy**

MF Global was a broker-dealer and futures commission merchant that filed for Chapter 11 bankruptcy on October 31, 2011.<sup>2</sup> Dating back to the eighteenth century where it began as a sugar trading business, MF Global’s modern foray into the financial industry came in 2007 when it split off from the Man Group.<sup>3</sup> In hopes of turning the ailing company around after three years of

---

<sup>1</sup> Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act), Pub. L. 111-203, 124 Stat. 1376, 1376 (2010).

<sup>2</sup> Aaron Lucchetti & Mike Spector, *The Unraveling of MF Global*, WALL ST. J. (Dec. 31, 2011), <http://online.wsj.com/articleSB10001424052970203686204577117114075444418.html>.

<sup>3</sup> James O’Toole, *Sorting through the MF Global debacle*, CNNMONEY (Dec. 19, 2011), [http://money.cnn.com/2011/12/19/news/companies/mf\\_global/index.htm](http://money.cnn.com/2011/12/19/news/companies/mf_global/index.htm).

subpar performance, MF Global hired John Corzine, former senator and governor of New Jersey and ex-CEO of Goldman Sachs, as its CEO.<sup>4</sup> Corzine had big plans for MF Global's future. He envisioned MF Global as becoming one of the major players among Wall Street's financial giants, acting not only as broker-dealer, but offering underwriting and advisory services as well.<sup>5</sup> Much of the firm's excessive risk taking can be traced back to Corzine's ambitious plan to effectuate his vision.

Corzine joined MF Global amidst threats from credit-rating agencies to downgrade MF Global's debt and complaints from unhappy shareholders about the firm's poor performance.<sup>6</sup> Consequently, Corzine needed a quick way to boost MF Global's profitability. He found his solution by investing big in European sovereign debt, which boosted revenue in late 2010 by \$39 million.<sup>7</sup> By purchasing European bonds that paid large coupon rates and then immediately posting these bonds as collateral for short-term borrowing, MF Global was able to pocket the difference between the interest rate it paid on loans and the coupon rate of the European bonds.<sup>8</sup> More importantly, because these deals were structured as repurchase-to-maturity agreements, an accounting loophole allowed the transactions to be reported as revenue without any of the excessive risk associated with the position showing up on the balance sheet.<sup>9</sup> In furtherance of his vision of MF Global's future and consistent with his risky bet on European sovereign debt, Corzine also worked to create a new, risk-loving environment at MF Global. He hired over 1,000 new traders and other employees, revised the pay structure to put an emphasis on year-end bonuses rewarding employees for successful trading, and actively encouraged traders to take riskier positions in the market.<sup>10</sup>

---

<sup>4</sup> *See id.*

<sup>5</sup> *See id.*

<sup>6</sup> Lucchetti & Spector, *supra* note 2.

<sup>7</sup> *Id.*

<sup>8</sup> Felix Salmon, *What happened at MF Global*, REUTERS (Nov. 1, 2011), <http://blogs.reuters.com/felix-salmon/2011/11/01/what-happened-at-mf-global/>.

<sup>9</sup> Tiffany Kary, *MF Global Accounting Technique Under Review, Schapiro Says*, BLOOMBERG BUSINESSWEEK (Dec. 02, 2011), <http://www.businessweek.com/news/2011-12-02/mf-global-accounting-technique-under-review-schapiro-says.html>.

<sup>10</sup> Lucchetti & Spector, *supra* note 2.

The investment in European sovereign debt posed two great risks to MF Global: first, that the European nations would default on the debt; and second, that weakening confidence in the European markets would reduce the value of the bonds as collateral.<sup>11</sup> Unfortunately, Corzine was more comfortable with the firm's exposure to European debt than MF Global's counterparties were.<sup>12</sup> Although Corzine's belief that Europe would not let the nations default on bond payments has so far proved true, the liquidity risk associated with the European debt put MF Global into financial strain. As trading partners required MF Global to post greater margin payments, and as clients, fearing the firm's excessive risk, pulled out, MF Global found itself without the cash necessary to service its short-term debt.<sup>13</sup> Unable to meet its obligations, Corzine put the company up for sale. Although Interactive Brokers expressed interest, during deal negotiations it was discovered that up to \$1.2 billion from customers' accounts was missing.<sup>14</sup> This shortfall forced MF Global to file for bankruptcy.<sup>15</sup>

### C. What Went Wrong at MF Global?

Since MF Global filed for Chapter 11, many are asking why the company was able to take on so much risk to the point of driving it to bankruptcy without any regulatory authority stepping in. After all, MF Global displayed two qualities that many claim to be central to the financial crisis of 2008—excessive leverage and financing of long-term investments with short-term borrowing. Loopholes in financial reporting and inefficient regulatory schemes may provide some answers.

#### 1. Loopholes in Financial Reporting

MF Global used an accounting loophole that allowed it to hide exposure to European sovereign debt off the balance sheet.<sup>16</sup> This loophole was made possible by Corzine's decision to structure

---

<sup>11</sup> Salmon, *supra* note 8.

<sup>12</sup> *See id.*

<sup>13</sup> *Id.*

<sup>14</sup> *See* O'Toole, *supra* note 3.

<sup>15</sup> *Id.*

<sup>16</sup> Kary, *supra* note 9.

the European trades as repurchase-to-maturity agreements.<sup>17</sup> Under these agreements, MF Global would borrow money using European bonds as collateral.<sup>18</sup> Because the loans would become due on the maturity dates of the bonds posted as collateral, MF Global may never have to take the bonds back into possession, allowing the firm to count the bonds as “sold.”<sup>19</sup> This structure, which is legal and complies with the Federal Accounting Standards Board's practices, allowed MF Global to report \$6.3 billion in exposure to European sovereign debt when the true figure was \$11.5 billion.<sup>20</sup> This technique is also what allowed Corzine to report an increase in revenues of \$39 million so quickly after taking over.<sup>21</sup> MF Global's ultimate fate makes it clear that the firm carried substantial risk associated with such a large position in European sovereign debt, even though the risk did not show up on the balance sheet. Over time, MF Global's counterparties lost confidence in the quality of the debt and the firm lacked the requisite liquidity to secure more financing.<sup>22</sup>

Some speculate that MF Global may also have used a technique referred to as “window dressing” to hide its true level of debt from investors.<sup>23</sup> Also legal, window dressing involves a business briefly shedding its short-term debt at the end of each fiscal quarter so that it may report lower amounts of debt than the business actually carries during the quarters.<sup>24</sup> The Wall Street Journal reported “in each of the past seven quarters, from late 2009 to mid-2011, MF Global's quarter-end borrowings were an average 16% lower than the quarterly average.”<sup>25</sup> Notably, MF Global's short-term borrowings peaked at \$28.4 billion during its third quarter in 2010, but that number was reduced to \$18.7 billion by the time of the

---

<sup>17</sup> *Id.*

<sup>18</sup> Salmon, *supra* note 8.

<sup>19</sup> Nanette Byrnes, *Analysis: MF Global proves Enron-era accounting lives on*, REUTERS (Dec. 1, 2011), <http://www.reuters.com/article/2011/12/02/us-mfglobal-accounting-idUSTRE7B02PS20111202>.

<sup>20</sup> See Kary, *supra* note 9.

<sup>21</sup> Byrnes, *supra* note 19; Lucchetti & Spector, *supra* note 2.

<sup>22</sup> See Salmon, *supra* note 8.

<sup>23</sup> Michael Rapoport, *MF Global Masked Debt Risks*, WALL ST. J. (Nov. 4, 2011), <http://online.wsj.com/article/SB10001424052970204621904577015950376439984.html>.

<sup>24</sup> *Id.*

<sup>25</sup> *Id.*

quarterly filing.<sup>26</sup> The discrepancy in numbers is significant because with increased short-term borrowing comes greater risk of running out of the liquidity needed to continuously borrow.<sup>27</sup> This is precisely what happened to MF Global as counterparties to the repos demanded more collateral.<sup>28</sup> MF Global maintained that debt declined for legitimate reasons at the end of each quarter, but the Wall Street Journal “found that in 2009 to 2010, primary dealers as a group reduced a key form of short-term borrowing by an average of 42% at the end of fiscal quarters from the peak level during the same quarter.”<sup>29</sup> Although MF Global was not a primary dealer, given Corzine’s aspirations for what the company would become, as well as his increased emphasis on risk taking, the fact that MF Global’s trend in its reporting of short-term borrowings mirrors that of primary dealers may be significant.

## 2. Protection of Customers’ Accounts

MF Global’s financial strain brought to light a shortfall in customer accounts of up to \$1.2 billion.<sup>30</sup> Amid bankruptcy, many are wondering why no regulator discovered the fact that MF Global was mingling client and company assets without posting sufficient collateral in customer accounts. An examination of the regulatory structure may provide some insight. MF Global faced two primary regulators: the Securities and Exchange Commission (“SEC”) oversaw it as a broker-dealer, while the Commodity Futures Trading Commission (“CFTC”) oversaw the futures commission merchant arm.<sup>31</sup> All futures commission merchants under the purview of the CFTC are required to keep customer accounts segregated from company funds at all times.<sup>32</sup> A firm like MF Global may only use customer funds if it puts adequate collateral in place, such as U.S. government bonds.<sup>33</sup> The substantive law barring mingling of customer funds with company assets is in place, so why was the law

---

<sup>26</sup> *Id.*

<sup>27</sup> *Id.*

<sup>28</sup> See Salmon, *supra* note 8.

<sup>29</sup> Rapoport, *supra* note 23.

<sup>30</sup> Lucchetti & Spector, *supra* note 2.

<sup>31</sup> *MF Global Warning Signs Spotlighted in Congress*, 18 No. 7 MONEY MANAGER’S COMPLIANCE GUIDE NEWSL. 3 (2012).

<sup>32</sup> Kary, *supra* note 9.

<sup>33</sup> O’Toole, *supra* note 3.

not followed? Gary Gensler, the chairman of the CFTC, suggests that inadequate resources may be partially to blame.<sup>34</sup> The CFTC oversees 125 futures commission merchants, but with fewer than twenty examiners, CFTC examinations are rare or nonexistent.<sup>35</sup> Gensler said he will urge Congress to provide him with thirty to forty percent more employees next year.<sup>36</sup> Because of the CFTC's inability to conduct its own examinations, it must rely on help from self-regulating organizations ("SROs") like the Chicago Mercantile Exchange ("CME") in overseeing the futures commission merchants.<sup>37</sup> "CME Group was responsible for day-to-day monitoring of the brokerage's trade practices as well as for auditing and reviewing the firm's segregated fund statements."<sup>38</sup> However, the ability of the CME to effectively oversee its members depends at least in part on auditors ferreting out the problems to begin with.<sup>39</sup> Regulators look over audited reports, but their review does not go so deep as to discover errors like those committed by MF Global.<sup>40</sup> Because MF Global was a broker-dealer and futures commission merchant, PricewaterhouseCoopers ("PwC"), MF Global's auditor, was required to "annually review the procedures for safeguarding customer and firm assets in accordance with the Commodity Exchange Act."<sup>41</sup> If indeed MF Global was combining client and company assets for some time, perhaps PwC is to blame for not bringing this fact to the attention of the CFTC. Regulators have subpoenaed PwC for information regarding the segregation of clients' funds.<sup>42</sup>

Another possible reason for MF Global's mingling of customer and company assets going undiscovered is that there are simply too many regulators. "MF Global reported to and was supervised by 20 U.S. regulators, SROs and exchanges."<sup>43</sup> Overlap in supervision made it

---

<sup>34</sup> Kary, *supra* note 9.

<sup>35</sup> *Id.*

<sup>36</sup> *Id.*

<sup>37</sup> *Id.*

<sup>38</sup> *MF Global Warning Signs Spotlighted in Congress*, *supra* note 31.

<sup>39</sup> Francine McKenna, *Auditor PwC Should Have Been on Top of MF Global*, AM. BANKER (Nov. 04, 2011), <http://www.americanbanker.com/bankthink/PwC-MF-Global-commingling-client-funds-1043821-1.html>.

<sup>40</sup> *See id.*

<sup>41</sup> *Id.*

<sup>42</sup> *Id.*

<sup>43</sup> *MF Global Warning Signs Spotlighted in Congress*, *supra* note 31.

so that for oversight to be effective, information would need to be shared among the regulators.<sup>44</sup>

#### **D. Will Dodd-Frank Help Prevent Similar Bankruptcies in the Future?**

MF Global was the first major bankruptcy following the enactment of the Dodd-Frank Act. This has put Dodd-Frank into the spotlight and raised the question: has it helped? MF Global failed because of a liquidity shortfall resulting from excessive exposure to European sovereign debt that possibly led to the use of customers' funds. The substantive law requiring segregation of client money and limited use of that money exists.<sup>45</sup> Therefore, if it turns out that MF Global actually did use client funds to meet its liquidity needs, that is a problem of the law not being followed, not of the law not being in place.

The more interesting inquiry is whether Dodd-Frank will help to alert regulators of excessive leverage and exposure to risky assets. Dodd-Frank calls for the formation of the Financial Stability Oversight Council.<sup>46</sup> The Council will have the authority to determine that "the nature, scope, size, scale, concentration, interconnectedness, or mix of the activities of the U.S. nonbank financial company could pose a threat to the financial stability of the United States."<sup>47</sup> The Council can then recommend that the Board of Governors of the Federal Reserve System implement more stringent regulation regarding risk-based capital requirements, leverage limits, liquidity requirements, short-term debt limits and risk management requirements.<sup>48</sup> These additional regulations might have prevented MF Global from going bankrupt, but because of its relatively small size and newness to the financial industry it seems unlikely that the Council would have determined that MF Global posed a threat to the U.S. economy. Consequently, MF Global would not have been subject to additional prudential standards. However, even if firms of MF Global's size are not subject to additional regulations, that outcome would not be so bad. If a nonbank financial institution is

---

<sup>44</sup> *Id.*

<sup>45</sup> Kary, *supra* note 9.

<sup>46</sup> Dodd-Frank Act, H.R. 4173, Pub. L. 111-203 § 111, 124 Stat. 1376, 1392 (2010) (to be codified at 12 U.S.C. § 5321).

<sup>47</sup> Dodd-Frank Act § 113.

<sup>48</sup> Dodd-Frank Act § 115.

deemed not to pose a significant threat to the economy, perhaps it is best to let the market weed out those institutions rather than trying to save them through heavy-handed regulation.

However, for that system to work, disclosure must accurately reveal a company's financial condition and exposure to risk to investors and regulators. The repurchase-to-maturity loophole must be closed so that companies cannot disguise risky assets as revenue. Additionally, the use of "window dressing" to hide real levels of debt needs to be addressed. In 2010, the SEC proposed a rule requiring additional disclosure regarding short-term borrowings, but the rule has yet to become final.<sup>49</sup> Tighter accounting principles will not substantively bar a company from becoming too leveraged or taking on excessive risk, but at least investors and clients will know a company's true financial condition. The fact that companies take such efforts to hide true debt levels from their financial statements supports the idea that excessive leverage is seen as undesirable. Closing the accounting loopholes may have a deterrent effect on relying heavily on short-term borrowing if companies know that investors will see their true debt levels.

Trey Flaherty<sup>50</sup>

---

<sup>49</sup> See Short-Term Borrowings Disclosure, 75 Fed. Reg. 59,866 (proposed Sept. 17, 2010) (to be codified at 17 C.F.R. pts. 249, 299).

<sup>50</sup> Student, Boston University School of Law (J.D. 2013).