Democratic Addendum
to the
Majority Staff Report on MF Global

PREPARED BY
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COMMITTEE ON FINANCIAL SERVICES
112TH CONGRESS

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Introduction

On November 15, 2012, Chairman Randy Neugebauer of the Subcommittee on Oversight & Investigations released a majority staff report on the collapse of MF Global. Ranking Member Michael Capuano, who first requested holding subcommittee hearings on MF Global's collapse and missing customer funds, has been supportive of the subcommittee's year-long investigation.

The main reason Ranking Member Capuano did not sign onto the majority staff report was that he did not have sufficient opportunity to review the final version or to gather input and reactions to its recommendations from other Members of the Subcommittee and related regulators. He, along with the other Members of the Subcommittee, received the final majority staff report the day it became public.

While we agree with a number of the majority staff report's observations and recommendations, others require additional commentary which we explain here in this Addendum. In addition, we think the Subcommittee should take the responsibility of offering certain specific proactive proposals rather than generally calling on Congress to take action.

We appreciate Chairman Neugebauer's efforts and look forward to working with him on MF Global and other issues in the future.

Process

Throughout the report, the term "Subcommittee" is used to describe the *majority staff* of the Subcommittee on Oversight & Investigations, e.g. "the Subcommittee recommends" and "the Subcommittee views". As a point of clarification for readers, only measures and matters officially voted on and adopted by the Committee reflect the views of the Committee. Per Rule 4(d) of the Committee on Financial Services, the following disclaimer is missing from the cover of the report: "This report has not been officially adopted by the Committee on Financial Services and may not necessarily reflect the views of its Members."

Highlights of MF Global's Collapse

Since the first few days and weeks after MF Global's unraveling and ultimate collapse, two distinct events became clear: the company's bankruptcy and its loss of customer funds. In assessing what next steps are needed in response to MF Global's collapse, Congress and regulators should step back to remember what its roles are regarding these two developments.

While it is our hope that American firms thrive and flourish, there will always be companies that are not successful. Our job as Members of Congress is to ensure there is a fair playing field in the marketplace, clear information available for investors, and rules are enforced. Regulators which oversaw MF Global have a responsibility to protect investors and maintain a healthy financial system overall.

Bankruptcy

The majority staff report concludes that MF Global's bankruptcy was caused by the executive decision to turn the company into an investment bank. A press release issued the day before the staff report was released by the majority stated: "Decisions by Jon Corzine to chart a radically different course for MF Global and try to turn the 230-year-old commodities broker into a full-service investment bank were the cause of the firm's bankruptcy and failure to protect customer funds..."

We do not fully share this assessment. MF Global's shift to becoming an investment bank was not problematic in and of itself, as is evident by existing profitable investment banks. But its particular investments posed substantial liquidity risks which proved unsustainable, and MF Global's increasing exposure, inadequate capital and failure to report these investments earlier intensified the end result.

Preventing MF Global or other companies from failing should not be the focus. Rather, ensuring that investors have access to all relevant financial firm data should be our priority. For these reasons, our main concern is not executive decisions regarding investments, but improving reporting rules to ensure that investors have full transparency.

Loss of Customer Funds

The majority staff report, and the above quote, also portrays the transformation of the company strategy as directly causing customer funds to be inappropriately used. We do not share this assessment. Any investment bank can go bankrupt without misusing investor funds. We believe MF Global's use of the Alternative Method (a practice used by only a few firms to calculate the amount required to be set aside in secured accounts) and its lack of oversight in using it were contributing factors to the loss of customer funds. MF Global's predecessor, the Man Group, first elected to use this approach in 2005 and its use was continued under Corzine.

Unrelated to the specific investment risks MF Global was taking with European sovereign debt, this accounting rule allowed MF Global to take opaque and excessive risks with customer funds. It appears that in the final, chaotic days of MF Global, poor internal record-keeping combined with the use and insufficient oversight of the Alternative Method made the transfer and loss of customer funds possible.

We support ending this accounting rule, strengthening protections for customer funds, and ensuring that regulators have the tools needed to monitor if customer funds are being treated appropriately.

Response to Majority Staff Report

Customer Funds – Alternative Method, Segregation & Disclosure

We particularly agree with the majority staff report's recommendations to end the Alternative Method and commend the National Futures Association (NFA) and the U.S. Commodity Futures Trading Commission (CFTC) for taking recent steps to ban it. We encourage regulators to move as quickly as possible in implementing this reform.

We understand that it may not be practical or even desirable to fully segregate customer funds from futures commission merchants (FCMs) or other customers. However, we encourage regulators to review if the Net Liquidation Method provides adequate protection of customer funds and to study ways to protect these funds even further.

We strongly support the majority staff report's recommendation that the CFTC consider extending comparable protections for customers of domestic exchanges to customers of foreign exchanges.

Regardless, we urge regulators to strengthen existing disclosure requirements to customers so that they will better recognize and understand the risks they face when they invest their funds in one place versus another. Many times disclosures result in overly complicated language that the average person cannot decipher, ultimately rendering the disclosure useless. Often, disclosures are contained in obscure footnotes that few people read. We urge regulators to aim for a balance of thorough yet straight-forward disclosures.

Merge SEC and CFTC

We agree with the recommendation to consider merging the U.S. Securities and Exchange Commission (SEC) and CFTC. We believe one of the shortcomings of the Wall Street Reform & Consumer Protection Act was its lack of consolidating existing regulators. Merging the SEC and CFTC is a great place to start. Ranking Member Barney Frank and Ranking Member Capuano recently introduced legislation which would achieve this. Since both the majority staff report and the Democratic Addendum support this merger, we believe that success in this endeavor requires sufficient financial support. This legislation therefore provides the merged entity with a new funding stream, independent of the appropriations process. Such funding would provide sufficient resources to increase oversight of FCMs and broker-dealers such as MF Global.

While Congress considers this legislation, we also recommend fully funding the SEC and CFTC to ensure they are able to protect investors and regulate financial markets. Both the SEC and CFTC should be funded at the President's Fiscal Year 2013 requested level of $1.566 billion and $308 million, respectively. These funding increases should be immediately and separately implemented.

Shared Accountability

We agree with the majority staff report's conclusion that the federal regulators (CFTC and SEC) lacked sufficient coordination with one another.

However, we note that while the majority staff report implies that the SEC and CFTC had direct oversight of MF Global, they, in fact, did not. The primary oversight regulators of MF Global were self-regulatory organizations (SROs) – the CME Group and Financial Industry Regulatory Authority (FINRA). The SEC and CFTC had regulatory authority over MF Global, but the responsibility to directly supervise and examine the firm was delegated to these SROs.

We believe that the SROs share some of this accountability. We wonder why CME Group was not able to more closely monitor an entity in such dire straits, or to order MF Global to not use the Alternative Method given its inadequate capital. While the CFTC's pending proposal to ban the Alternative Method may obviate this concern to some extent, we recommend that CME Group and the CFTC, its federal regulator, consider what better approaches CME Group could take in future similar situations.

We also agree that those responsible SROs need increased communication and coordination as well. We, therefore, support the recommendation of the majority staff report that the SROs enter into MOUs to share information amongst themselves.

New York Fed Primary Dealer Designation

While the majority staff report omitted this, it is relevant to note that until the 1990s, the Federal Reserve Bank of New York (New York Fed) conducted a more thorough review and rigorous approval process of its primary dealer applicants. Even before that, the number of primary dealers has been in decline, which may result in less competitive auctions of U.S. securities and an increased cost of U.S. debt.

We recommend that the New York Fed return to thorough reviews of primary dealer applicants and also consider occasionally reviewing those designated firms after their initial designation for new and updated, relevant information. A good actor can turn bad at a later time.

Bad Actors Need Loopholes To Exist

We agree that Mr. Corzine has earned his share of the blame for all that occurred at MF Global. He certainly stretched the bounds of what is legal and may well have gone beyond them – and we agree with the majority staff report that others will make that particular determination. In addition, we would have hoped Corzine would aspire to an even higher level of responsibility to protect others from potential charges of favoritism. Nonetheless, a reasonable person could read the majority staff report and conclude that Corzine was solely responsible for MF Global's collapse and the loss of customer funds. For example, the first finding of the majority staff report reads "Jon Corzine Caused MF Global's Bankruptcy and Put Customer Funds at Risk".

We believe that the board bears a significant share of the responsibility, particularly for setting the risk parameters and approving the company's growing exposure. In addition, we believe that

neither Corzine nor any other individual could have taken these actions if the rules had been tighter and enforcement of them had been more stringent. Better rules and stricter enforcement would have made any such attempts more difficult and more readily apparent to regulators and investors.

Off-Balance Sheet Rules

We agree with the majority staff report and commend the Financial Accounting Standards Board (FASB) and FINRA for their initial steps towards changing the treatment of repo-to-maturity (RTM) transactions so that they are listed as secured borrowing instead of sales. We further recommend that all such loopholes be closed so that all transactions are reported on balance sheet.

Rules allowing off-balance sheet transactions masked significant problems and risks at Enron, Lehman Brothers, and now MF Global. All financial aspects of any company should be transparent, easily comparable, and simple to understand. Only when all risks are accurately reflected will investors, regulators, and the public truly be able to make informed decisions.

Credit Rating Agencies

While we agree with the majority staff report's findings that the credit rating agencies could have downgraded MF Global more quickly, we disagree with the assertion that they failed in their ratings of MF Global overall. Ranking Member Capuano, who has been a vocal critic of their past performance and the leading proponent of the provisions related to credit rating agencies in Wall Street reform, notes that the credit rating agencies did a better job with rating MF Global than they did rating many market players in the years leading up to the 2008 financial crisis. In the case of MF Global, the credit rating agencies at least rated them as essentially junk from the beginning.

It is also important to note that the Wall Street Reform & Consumer Protection Act has already produced some improvement in this area, which was not discussed in the majority staff report. Here are a few examples:

- As required by the law, the SEC created the Office of Credit Ratings, which examines the rating agencies annually and has the authority to deregister an agency. To date, it has issued two reports detailing how rating agencies are complying with new financial reform rules that among other things require disclosure of methodologies, rating performance and third-party due diligence.
- The reform legislation also improves the governance of rating agency boards by requiring at least half of the Directors be independent.
- The reform law provides investors with new private rights of action against rating agencies when they knowingly or recklessly fail to conduct a reasonable investigation of the facts or to obtain analysis from an independent source. In addition, rating agencies are now held to the same liability standard as accountants and other experts when their ratings are included in the prospectus of a security.

The majority staff report correctly states that the Committee on Financial Services enacted bipartisan reform to reduce the reliance on credit rating agencies. However, it fails to state that, under Republican leadership, in July 2011 the Committee passed a proposal to weaken credit rating agency liability when their ratings are included in prospectuses – a change to a provision enacted in Wall Street reform. This proposal has not been brought to the House floor for a vote.

Misrepresentation to FINRA

We also note that MF Global blatantly misled FINRA in September 2010 when it responded to FINRA's inquiry about having exposure to European sovereign debt by saying it did not have any such exposure. We urge FINRA to take regulatory action against MF Global on this misrepresentation to the best of its abilities and hold MF Global accountable. If FINRA had known of this exposure in September 2010, it could have forced MF Global to appropriately disclose its investment that much earlier and take appropriate capital charges for its investment at that time.

If FINRA determines that it does not have the authority to take these enforcement actions, we recommend that the SEC issue rules providing these powers. We should take all necessary steps to ensure that regulating bodies can receive accurate and timely information from the firms they oversee so that this type of bad actor does not fall through the cracks again in the future.

Investigations by Federal Regulators

It is necessary to note that the majority staff report indicates that MF Global and its employees are the subject of an investigation by the U.S. Department of Justice, SEC, and CFTC. However, consistent with their policies to neither confirm nor deny any ongoing investigations, none of them have stated that they are investigating MF Global. We do agree with the majority staff report's assumption that these agencies have been thoroughly examining this, and if they are not, we urge them to do so.

Report of MF Global Trustee

Finally, while most of the recommendations suggested in the June 2012 Report of MF Global Trustee James Giddens are included in the majority staff report, we also support further examination, and consideration of the Trustee's remaining recommendations

- To create a fund, to protect futures and commodities customers under a certain threshold and to implement suitability standards for FCM customers
- To simplify CFTC rules for bulk transfers and claims in an FCM liquidation proceeding
- To enact legislation explicitly authorizing Trustee standing on behalf of customers.

We are currently working on draft proposals to advance these recommendations and believe the Subcommittee should hold hearings to consider them. We also urge regulators to examine these ideas in full and implement those changes that are already within their authority.

Conclusion

We conclude by noting that, overall, this is not just about one company or one person. There will always be bad actors and bad companies. These recommendations are intended to limit the bad actions of all current and future players so that this does not happen again.

We hope that all regulators continue to review their rules and improve upon them in light of MF Global's collapse. Increased transparency should remain a top priority which can be achieved by sharing all financial aspects of a company. In addition, customers should be able to clearly and easily understand the risks they face when investing in companies – if their funds are secure and separated, if they can be moved to foreign exchanges, and if there are limited protections on those funds if they are moved.

We also believe the Subcommittee should do more than recommend that Congress take action on several of these ideas, such as credit rating agency reform, merging the SEC and CFTC and civil liability for officers and board of directors. Instead, it should draft and submit specific legislation to make these recommendations a reality.

We should continue to watch the investigations related to MF Global and the regulatory changes that agencies are implementing as a result of it. We should also continue to monitor this sector of the industry, especially with an eye towards systemic issues, to ensure that something like this does not happen again.

Michael E. Capuano
Ranking Member,
Subcommittee on
Oversight & Investigations

Barney Frank
Ranking Member,
Financial Services Committee

Stephen F. Lynch
Member of Congress

Maxine Waters
Member of Congress

Brad Miller
Member of Congress

Joe Baca
Member of Congress

Keith Ellison
Member of Congress

James A. Himes
Member of Congress

John C. Carney, Jr.
Member of Congress

Appendix A

We believe that a full investigation requires input from all parties and an open dialogue. Therefore, we offered the related agencies, which include CFTC, SEC, CME Group, New York Fed, FASB, FINRA, and NFA, an opportunity to submit comments in response to the majority staff report. Only the NFA accepted the offer and provided a response. Those comments appear in Appendix B.

We regret that so many declined our invitation to comment on the majority staff report. We hope that this does not imply they are unwilling to work cooperatively to improve the system, that they agree with every word of the majority staff report or that they would prefer to work in secret to address the concerns brought to light by the majority and minority.

Appendix B

NFA NATIONAL FUTURES ASSOCIATION

November 20, 2012

The Honorable Randy Neugebauer
Chairman
Subcommittee on Oversight and Investigations
The Committee on Financial Services
United States House of Representatives
Washington, D.C. 20515

The Honorable Michael E. Capuano
Ranking Member
Subcommittee on Oversight and Investigations
The Committee on Financial Services
United States House of Representatives
Washington, D.C. 20515

Dear Chairman Neugebauer and Ranking Member Capuano:

National Futures Association appreciates the opportunity to comment on the staff report prepared for the House Subcommittee on Oversight and Investigations regarding the MF Global, Inc. (MFGI) liquidation. As mentioned in the report, NFA has already implemented one of the recommendations detailed in the report. The report states that MFGI's use of the "Alternative Method," which permits FCMs to exclude a customer's excess margin funds from the amount that must be set aside in secured accounts for customers trading on foreign exchanges, allowed MFGI's parent to use certain customer funds to meet the company's liquidity needs. The report further states that MFGI's use of the Alternative Method contributed to the $900 million shortfall in customer funds. On May 29th, NFA submitted proposed amendments to NFA Financial Requirements Section 16 and its related Interpretive Notice regarding FCM Financial Practices and Excess Segregated Funds/Secured Amount Disbursements to prohibit FCMs from using the Alternative Method in determining the FCM's secured amount requirement. The Interpretive Notice further requires the FCM to use the method that calculates net liquidating equity plus the market value of any securities held in customer's accounts when determining the FCM's secured amount requirement. These amendments were approved by the CFTC and were effective on September 1, 2012.

This particular change is just one of several changes and initiatives taken by NFA to further safeguard customer funds. Attached as an exhibit to this letter is a summary of the actions taken by NFA to strengthen the protection of customer funds held by its members. The process of refining and improving regulatory protections is ongoing and the initiatives outlined in the attached exhibit do not mark the end of our efforts.

If you have any questions concerning this letter, please do not hesitate to contact the undersigned at (312) 781-1390 or droth@nfa.futures.org or Karen Wuertz at (312) 781-1335 or kwuertz@nfa.futures.org.

Sincerely,

Daniel J. Roth
President

Attachment

NFA NATIONAL FUTURES ASSOCIATION

Enhancement of Customer Protection—Current Initiatives

Customers in the futures markets must know that their funds are safe. It is the job of the regulators to provide the public with the highest level of assurance possible regarding the financial integrity of the futures markets. In light of the failure of two FCMs, the time tested measures to monitor the safety of customer segregated funds have to be changed. NFA has adopted the following changes and initiatives to further safeguard customer funds:

MF Global Rule—All FCMs are now required to provide regulators with immediate notification if they draw down their excess segregated funds (funds deposited by the firm into customer segregated accounts to guard against customer defaults) by 25% in any given day. Such withdrawals must be approved by the CEO, CFO or a financial principal of the firm and the principal must certify that the firm remains in compliance with segregation requirements. **Status: Rule has been approved by NFA and the CFTC and became effective September 1.**

FCM Transparency—All FCMs must file certain basic financial information about the firm with NFA and that information will be posted on NFA's web site. The information includes data on the FCM's capital requirement, excess capital, segregated funds requirement, excess segregated funds and how the firm invests customer segregated funds. **Status: Rule has been approved by NFA and the CFTC. Information will be displayed on NFA's web site by November 1.**

Electronic Confirmation of Segregated Bank Balances—NFA's switch to an e-confirmation process of segregated fund balances held in banks uncovered the fraud at Peregrine. NFA has since conducted e-confirmations for all segregated bank accounts maintained by FCMs for which NFA is the Designated Self-Regulatory Organization ("DSRO") and noted no violations of segregation requirements. NFA continues to utilize e-confirmation in its ongoing audits of the FCMs for which it is the DSRO. **Status: Completed and ongoing.**

Granting Regulators Online, View-Only Access to Customer Segregated Accounts—All FCMs will be required to grant their DSRO online, view-only access to information on customer segregated bank accounts. SROs will now be able to check balances in customer segregated bank accounts at any time without notice to either the FCM or the bank. **Status: Rule has been approved by NFA's Board and is pending approval at the CFTC. We expect the rule to be approved and implemented by late fall.**

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Daily Confirmations from all Segregated Funds Depositories—NFA and the CME have committed to building a system that will provide for all depositories holding customer segregated funds on behalf of an FCM to report balances daily to SROs. The SROs will perform an automated comparison to the reports filed by the FCMs to identify any suspicious discrepancies. **Status: This program will be operational in 2013.**

Internal Controls Guidance—NFA, the CME and other SROs are developing more specific and more stringent standards for the internal controls that FCMs must follow to monitor their own compliance with regulatory requirements. **Status: Proposals may be considered at NFA's November Board meeting.**

Insurance Study—The possibility of providing some form of insurance protections for futures customer accounts, whether based on a SIPC-type model or otherwise, has been discussed. Unfortunately, there has been no formal study of the issue or calculation of the costs since 1985. **Status: NFA is committed to commission such a study either on its own or with other industry groups.**

Review of NFA Audit Procedures—A special committee consisting of NFA's public directors, has commissioned an independent review of NFA's audit procedures in light of the Peregrine fraud. The study is being conducted by Berkeley Research Group, the same firm the SEC retained after the Madoff scandal. **Status: The study will be completed by the end of 2012.**

Detecting and combating fraud is central to our mission. No system of regulation can ever completely eliminate fraud, but we must always strive for that goal. The process of refining and improving regulatory protections is ongoing and the initiatives outlined above do not mark the end of our efforts. We will continue to work with the CFTC, the industry and Congress to ensure that customers have justified confidence in the integrity of U.S. futures markets.

If you have any questions, please contact Dan Roth at (312) 781-1390 or droth@nfa.futures.org or Karen Wuertz at (312) 781-1335 or kwuertz@nfa.futures.org

Appendix C

We want to thank both the majority and minority staff involved in the writing the majority staff report and the Democratic Addendum. This was a year-long investigation involving three hearings, many interviews, and extensive document review. The majority staff in this effort includes Cliff Roberti, Joe Clark, Giselle Roget, Anne Marie Turner and Mark Epley. The minority staff in this effort includes Noelle Melton, Dominique McCoy, Lawranne Stewart, Kristofor Erickson, and Kellie Larkin. We also acknowledge the many staffers of Democratic members who participated in the MF Global hearings throughout the past year.

Appendix D

Below is a compilation of acronyms used in this addendum:

- CFTC – U.S. Commodity Futures Trading Commission
- FASB – Financial Accounting Standards Board
- FCM – futures commission merchants
- FINRA – Financial Industry Regulatory Authority
- New York Fed – Federal Reserve Bank of New York
- NFA – National Futures Association
- RTM – repo-to-maturity
- SEC – U.S. Securities and Exchange Commission
- SRO – self-regulatory organization