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CFTC Struggles To Gain Foothold Amid MF Global Meltdown

By **Ian Thoms**

Law360, New York (November 17, 2011, 8:39 PM ET) -- With reports Thursday that MF Global Inc. borrowed cash from customers without telling them or backing the loans, the unceasing revelations about the brokerage's collapse continue to sour investors' confidence in the reeling U.S. futures market and the ability of its chief regulator to handle the crisis, traders say.

Already struggling to assert itself in the messy MF Global meltdown, the U.S. Commodity Futures Trading Commission now faces the prospect that it missed a blatant crime. According to Thursday's reports, the commodities and derivatives brokerage, then led by its well-connected CEO Jon Corzine, borrowed customer cash without providing legally required collateral in the days leading to its Oct. 31 bankruptcy filing.

"If that were true, if they were actually improperly borrowing the money, there needs to be an arrest. That's fraud," said John L. Roe, a principal at BTR Trading Group Inc. in Chicago. "To me that's insane. Say what you will about Corzine and his politics, but he's certainly not a stupid man. I have difficulty believing he's a criminal."

Regulators have long suspected that MF Global commingled client money and company cash in violation of the Commodity Exchange Act, leading the firm to misplace some \$600 million. Chicago U.S. Attorney Patrick Fitzgerald and New York U.S. Attorney Preet Bharara issued subpoenas for MF Global records in hopes of finding the missing funds, the Wall Street Journal reported.

"This is going to destroy the U.S. futures market," said Anthony Garner, a British fund manager and MF Global customer. "This leaves the sensible, rational individual to distrust every financial institution."

For more than two weeks now, regulators from the CFTC and a host of other agencies have scoured MF Global's apparently sloppy books in search of the missing client funds, but turned up nothing. They don't even know exactly how much is missing.

"Exactly what the amount is hasn't been reconciled, exactly what happened, I don't think anyone knows at this point," said James B. Kobak Jr., of Hughes Hubbard & Reed LLP, counsel for a bankruptcy trustee liquidating the firm.

Despite its position as the firm's lead regulator and the agency with the most expertise in the relatively specialized field of futures trading, the CFTC has taken a backseat role in the aftermath of MF Global.

Ever since its chairman, Gary Gensler, decided to recuse himself from the agency's probe, the agency has deferred to the Securities Investor Protection Corp., which is overseeing the

firm's liquidation, traders and attorneys said.

Gensler stepped aside amid allegations that he slow-played a proposed regulation at the request of Corzine, who was Gensler's former boss at Goldman Sachs & Co.

The rule would have prevented brokerages from using customer funds for internal repurchase, or repo, transactions — currently legal but controversial arrangements some suspect led to the lost money in MF Global's case.

"Gensler probably made the right decision to recuse himself, but in doing so it seems like the CFTC has abdicated its responsibility to SIPC," Roe said. "So instead of handling something in which they have a great deal of expertise, the CFTC is stepping aside for SIPC, whose expertise is in securities."

Customers partially blame SIPC's lack of expertise in the futures market for delaying the return of their money. SIPC-selected and court-appointed trustee James W. Giddens' experience lies in the liquidation of securities firms, like Lehman Brothers Inc., not commodities and derivatives firms, like MF Global.

"It has taken some time to educate the trustee's team on the difference between a commodities firm's insolvency and securities firm's insolvency," said Trace Schmeltz, a partner with Barnes & Thornburg LLP and attorney for MF Global customers.

The CFTC could be doing more to bring Giddens and his team up to speed on the way the commodities market operates, several investors said.

"As of a certain point in time, there should have been rock-solid information on these accounts," said Schmeltz. "The trustee needs to get those reports out, let people verify them, and then give them their money back — and the CFTC could help with all that."

While Giddens has managed to move some client positions and return some cash, many of those who traded through the failed broker-dealer remain locked out of their accounts. CME Group Inc., the world's largest futures exchange, has seen a significant reduction in activity and its share price has fallen roughly 10 percent over the last week.

"As a result, there's a lot of money sitting on the sidelines," said Schmeltz. "It's not a crisis of confidence yet, but it has the propensity to become one."

To avoid a crisis, Schmeltz and others have been pushing Giddens to return money to customers more quickly. On Thursday, Giddens won bankruptcy court approval to release about \$520 million in funds that had been frozen.

The collateral transfer was made possible by a \$250 million guarantee by the CME Group, Giddens — a partner at Hughes Hubbard & Reed LLP — said in a motion.

But customers want Giddens to use MF Global's \$1.2 billion in excess equity and the \$250 million lifeline from the CME Group to return all customer funds now. Since the available funds far eclipse the estimated \$600 million shortfall, Giddens does not need to wait for a full accounting before conducting wholesale transfers, the customers contend.

Traders are also trying to convince Giddens to rely on account reporting already at its disposal, rather than wait for mailed claims, saying that they have a clear understanding of what their accounts should look like and could object if they don't agree with the trustee's ledger.

On Thursday, Sen. Chuck Grassley, R-Iowa, joined those calling on the CFTC and Giddens to return the funds as soon as possible. The senator said he has heard from farmers and co-op

managers who are unable to access capital needed to run their businesses.

"Uncertainty is a serious hurdle for any business, and farming is no different," Grassley said. "The CFTC and the trustee need to do all they can to find the remaining customer money, and the trustee needs to distribute it as soon as possible to limit the harm done to farmers and grain co-ops."

Though farmers and traders are frustrated with the CFTC and the trustee, they're also incredulous that CME Group didn't immediately step in and cover the missing \$600 million to ensure trading continued.

"A \$600 million loss is going to look very small when their exchange dries up," Roe said. "This is CME's business and no one should know more about it than them. ... I don't know what it is, maybe they were worried about their liability in all this. I don't know if they, forgive the phrase, decided to lawyer up and shut everything down."

While all these major players consult with their attorneys and try to clean up the calamity that MF Global has become, traders like Garner are left to themselves to try to digest the scraps of information that fall to him. He said he has gotten few details from CFTC regulators, who often tell him they can't provide legal advice when he asks for basic updates.

"That's the worst part of all this," Garner said. "I understand that they must be in chaos, but we've gotten no information that's understandable for a nonsecurities lawyer. It's a disaster."

Besides Giddens, the Hughes Hubbard & Reed LLP team working on the case under the SIPA includes James B. Kobak Jr. and Christopher K. Kiplok.

MF Global is represented by Kenneth S. Ziman, J. Gregory Milmo, J. Eric Ivester and George Panagakis of Skadden Arps Slate Meagher & Flom LLP.

The Chapter 11 case is In re: MF Global Holdings Ltd. et al., case number 1:11-bk-15059, in the U.S. Bankruptcy Court for the Southern District of New York.

The liquidation case is In re: MF Global Inc., case number 1:11-ap-02790, in the same court.

--Additional reporting by Hilary Russ. Editing by Kat Laskowski.

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