

## MF Global Revelations Keep Getting Worse

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- Shortfall estimated at \$1.2 billion or more (up from \$600 million)
- “Repo-to-Maturity” is a “Total Return Swap-to-Maturity,” a Type of Credit Derivative
- Probable Shortfalls Throughout 2011
- Regulators Waive Required Tests for Jon Corzine
- Jon Corzine to Credit Derivatives Head: Next Time “Double Up”  
***JT Note:*** Subsequent to this report Jim Parascandola told me that he was never told to increase the size of any position, albeit his trades were profitable.
- Questions About How MF Global Became a Primary Dealer
- MF Global Wrote Rubber Checks for some Electronic Checks for Others
- Tip-Offs for Some Customers?
- CFTC’s Gary Gensler Didn’t Act
- MF Global Debacle Damages a Key Global Market

**By Janet M. Tavakoli, President, Tavakoli Structured Finance, Inc.**

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## MF Global Revelations Keep Getting Worse

By Janet Tavakoli – November 21, 2011

When MF Global collapsed on October 21, it was the biggest financial firm to collapse since Lehman in September 2008. Then Chairman and CEO Jon Corzine is connected to the head of one of his key regulators, the Commodity Futures Trading Commission (CFTC), through his former protégé at Goldman Sachs, Gary Gensler. He also knows the Fed's William Dudley, a key member of the Fed's Open Market Committee, from their days at Goldman Sachs. The Fed approved MF Global's status as a primary dealer, a participant in the Fed's Open Market Operations, less than one year after Jon Corzine took its helm and beached it on a reef called leveraged credit risk. [**Note:** This sentence was corrected on 11/28 to reflect that Corzine joined MF Global in March 2010, before (not after) MF Global was awarded primary dealer status.]

MF Global's officers admitted to federal regulators that before the collapse, the firm [diverted cash from customers' accounts that were supposed to be segregated](#):

MF Global Holdings LTD. "violated requirements that it keep clients' collateral separate from its own accounts...Craig Donohue, CME Group's chief executive officer, said on a conference call with analysts today that MF Global isn't in compliance with the rules of the exchange and the Commodity Futures Trading Commission."

["MF Global Probe May Involve Hundreds of Millions in Funds,"](#) *Bloomberg News* – November 1, 2011 by Silia Brush and Matthew Leising

Cash in customers' accounts may be invested in allowable transactions, and MF was allowed to make extra revenue from the income. But what isn't allowed, and what MF Global apparently admitted to doing, is to commingle customers' money with its own and take money from customers' accounts to meet margin calls on MF Global's own allowable transactions. Even if all of the money is eventually clawed back and recovered, this remains an impermissible act. Moreover, full recovery—even if it is possible—is not the same as restitution. People have been denied access to their money, and businesses and reputations have been tarnished.

In layman's terms, you may buy a Rolls Royce with customers' excess cash, sell it at a profit, and pocket part of the profits. You may buy a Rolls Royce and try to resell it at a profit with your firm's cash. But you aren't allowed to take customers' money to make the car payments on your firm's Rolls Royce. If one engages in this impermissible activity, it becomes almost impossible to cover up if you have an accident driving your Rolls Royce.

## **Implausible Denial and an Ugly Surprise**

On November 1, Kenneth Ziman, a lawyer for MF Global, relayed information from MF Global to U.S. Bankruptcy judge Martin Glenn in Manhattan: "To the best knowledge of management, [there is no shortfall.](#)" If that sounded like a cover-up, it was, unless of course you prefer to believe that the "best knowledge" of management is actually no knowledge at all.

How long does it take to find more than \$600 million to \$1.2 billion of customers' money? MF Global's books seem so messed up that one person couldn't have created this chaos alone. A lot of people had to agree to throw away controls, standards, and procedures. I doubt this happened just in the final week or two before MF Global blew itself up.

"According to a U.S. official, MF Global admitted to federal regulators early Monday [October 31, 2011] that money was missing from customer accounts. MF Global acknowledged a shortfall in a phone call amid mounting questions from regulators as they went through the firm's books."

"[MF Global's Collapse Draws FBI Interest](#)," by Devlin Barrett, Scott Patterson, and Mike Spector, *WSJ*, November 2, 2011

The initial bankruptcy estimate was a shortfall of around \$600 million. As of Monday November 21, MF Global's liquidating trustee [believes the shortfall may be as much as \\$1.2 billion](#) and possibly even more.

## **"Repo-to-Maturity" is a "Total Return Swap-to-Maturity," A Type of Credit Derivative**

If you call a total return swap-to-maturity a "repo-to-maturity," you are much less likely to freak out regulators. Many regulators still remember that Long Term Capital Management (LTCM) used total return swaps (among other things). Jon Corzine should remember, too, since he was closely involved with LTCM when he headed Goldman Sachs. In September of 2011, FINRA seemed to catch on that MF Global's transactions were riskier than it previously thought and asked for more capital against these trades.

Part of AIG's acute distress in 2008 was due to credit default swaps, another type of credit derivative, linked to the risk of shady overrated collateralized debt obligations. The basic problem was risk on fixed income assets that could only go down in value combined with lots of leverage.

I'd like to interject a side note. I understand that some pundits tried to say that the *New York Times's* Gretchen Morgenson was incorrect when she wrote [MF Global was felled by derivative bets](#). She is correct. The pundits leaped to the conclusion that when she referred to credit derivatives and "swaps" that she meant credit default swaps, but she was referring to total return swaps, a type of credit derivative. (Later in the article she discussed a different topic, lack of transparency in credit default swaps, another type of credit derivative.)

MF Global's problematic trades were different from AIG's, but they were also derivatives, in fact, they were a form of credit derivative. The "repo-to-maturity" transaction was just a form over substance gimmick to disguise this fact. Specifically the transactions are total return swaps, a type of credit derivative, and the chief purpose of these transactions is *leverage*.

A total return swap-to-maturity includes a type of credit derivative. It allows you to sell a bond you own and get off-balance sheet financing in the form of a total return swap. Alternatively, you can get off-balance sheet financing on a bond with risk you want (but do not currently own so there is no need to sell anything) and take the risk of the default and price risk. (Price risk can be due both to credit risk and/or interest rate risk.) This is an off-balance sheet transaction in which the total return receiver (MF Global) has both the price risk and the default risk of the reference bonds. In this case, MF Global had the price risk and the default risk of \$6.3 billion [This was the reported net position in the annual report dated March 2011; MF Global's June 2011 filings revealed a gross \$11.4 billion long position, offset by 'short' positions of almost \$5 billion] of the sovereign debt of Belgium, Italy, Spain, Portugal, and Ireland. As it happened, the price fluctuations of this debt in 2011 weren't due to a general rise in interest rates, they were due to a general increase in the perceived credit risk of this debt.

Repo transactions are on balance sheet transactions, but they don't draw as much scrutiny from regulators. There was just one little problem. MF Global wanted the off-balance sheet treatment of a derivative, a total return swap, but it didn't want to call it a total return swap, so it used smoke and mirrors. Even if MF Global engaged in a wash trade at the end (if there is no default in the meantime) to buy back the bonds, MF Global would receive par on the bonds from the maturing bonds. The repurchase trade at maturity is a formality with no real (or material) economic consequence.

In other words, the "repo-to-maturity" exploits a form-over-substance trick to avoid calling this transaction a total return swap. Accountants paid by the form-over-substance seekers and asleep-at-the-switch regulators will sometimes, at least temporarily, go along with this sort of relabeling.

The fact that MF Global was exposed in a leveraged way to default risk and liquidity risk because of these transactions and that the risk was- linked to European sovereign debt was disclosed in [MF Global's 10K](#) for the year ending March 31, 2011, a required financial statement filed with the SEC. The CFTC and other regulators had the information right under their noses, but it appears they didn't understand that they were looking at a leveraged credit derivative transaction that could lead to margin calls that MF Global would be unable to meet.

The result is that yet another large financial institution has been felled when it couldn't meet margin calls due to the credit risk of fixed income assets combined with high leverage in an off-balance sheet transaction. The ugliest part of this story, however, isn't that MF Global got in over its head, it's that the bankruptcy trustee estimates customers' money to the tune of \$1.2 billion or more is still missing.

### **Probable Shortfalls Throughout 2011**

MF Global reportedly employed 35:1 leverage—some reports are 40:1—against a portfolio comprised around 20% of European Sovereign risks including Belgium, Italy, Spain, Portugal, and Ireland. MF Global would have had several trading days in 2011 with moves of 5% to 10% on this sovereign risk. MF Global was so thinly capitalized that this trade alone could eat up half of its capital. Any of MF Global's other asset positions moving the same way in 2011's highly correlated markets would have put MF Global in a position of negative equity.

From a risk management point of view, examiners have to consider the very strong possibility that MF Global had several negative equity days throughout 2011.

How did MF Global meet margin calls throughout 2011? It seems an investigation into money flows throughout 2011 is in order.

By the end of October, the combination of a \$90 million August legal settlement against MF Global coming due, increased capital calls by FINRA, and margin hikes from counterparties worried about MF Global's credit made it impossible for MF Global to cover up its shortfall.

### **Regulators Waive Required Tests for Jon Corzine**

[Jon Corzine resigned as Chairman and CEO of MF Global](#) on November 4, just days after the October 31 bankruptcy announcement. As a matter of corporate governance, holding the position of Chairman and CEO meant that Corzine had a lot of concentrated power with little oversight. Many question the wisdom of a corporate structure that allows officers to hold this dual position. (Ken Lewis, the Chairman and CEO that merged Bank of America into the poorhouse held this dual role, too. Lewis defended this practice at the Federal Reserve Bank of Chicago's Bank Structure Conference in 2003.) Corzine was the former governor of New Jersey and had been out of the active markets for twelve years. Prior to that, until 1999 he had been the CEO of Goldman Sachs.

The Financial Industry Regulatory Authority Inc. (FINRA) gave Jon Corzine a waiver from his Series 7 and Series 24 exams when he took the helm of MF Global in March 2010. The former is required for anyone involved in the investment banking or securities business including supervision, solicitation, or training of persons associated with MF Global, and that included Corzine. As an officer of MF Global the latter was required for Corzine, since he [had been out of the business for around 12 years](#) or more than six times the 2 year expiration date for reactivating these qualifications.

### **Jon Corzine to Credit Derivatives Head: Next Time "Double Up" (See note below)**

The test waiver by regulators seems to be blatant cronyism, because Corzine not only hadn't been involved in the day-to-day markets for more than a decade, his responsibilities at MF Global included active decision making. The waiver wasn't justified. Corzine reportedly authored the strategy for the MF Global killing trades, and he also had authority on the trading floor.

Jon Corzine pushed traders to increase their risk. According to an MF Global employee, Corzine knelt down beside Jim Parascandola, head of credit derivatives trading, and told him that next time he should "double up" on his winning protection bets on brokerages. Traders loved Corzine, because he pushed them to increase risk. Now the traders aren't lifting offers, they're pounding the pavement.

**JT Note:** Subsequent to this report Jim Parascandola told me that he was never told to increase the size of any position, albeit his trades were profitable.

## **MF Global Becomes a Primary Dealer Unregulated by the Fed: How Did That Happen?**

MF Global's financials were shaky ever since Man Group spun it off in 2005 and saddled it with a lot of debt. Yet [MF Global was added](#) to the Fed's list of 22 primary dealers in February 2011, less than one year after former Goldman CEO Jon Corzine came on board. [**Note:** This sentence was corrected on 11/28 to reflect that Corzine joined MF Global in March 2010, before (not after) MF Global was awarded primary dealer status.] Primary dealers buy and sell U.S. treasuries at auction and are a counterparty to the Fed's Open Market operations.

William C. Dudley is the president and chief executive officer of the FRBNY. He is also vice chairman of the Federal Open Market Committee (FOMC) and VP of the Markets Group, which oversees open market and foreign exchange trading operations and provisions of account services to foreign central banks and manages the System Open Market Account. Dudley is a former partner at Goldman Sachs (1986-2007), and he was Goldman's chief economist.

David Kotok of Cumberland Advisors has raised important questions about the fact that the Fed has dropped its role of surveillance of primary dealers, and [his commentaries are available here](#).

Besides trading treasuries, the big benefit to primary dealers is the perception that the Fed will provide funding to primary dealers during a systemic liquidity crunch. Just before Bear Stearns imploded, the Fed changed the rules so that non-U.S. banks, along with brokers that were primary dealers (as MF Global later became), were allowed to borrow through a program called a Term Securities Lending Facility (TSLF) to finance mortgage backed securities, asset backed securities, and more. TSLF's start date was too late to help Bear Stearns, and the program has now been discontinued, but the perception of a Fed safety net has precedence.

[Why did the Fed award prestigious primary dealer status to a shaky operation like MF Global, an entity it does not regulate?](#)

## **MF Global Stalled and Wrote Rubber Checks: Did Some Customers Get Better Treatment?**

The week before the bankruptcy, when customers asked for excess cash from their accounts, MF Global stalled. According to a commodity fund manager I spoke with, MF Global's first stall tactic was to claim it lost wire transfer instructions. Instead of issuing an electronic check or sending an overnight check, MF Global sent paper checks via snail mail, including checks for hundreds of thousands of dollars. The checks bounced. After the checks bounced, the amounts were still debited from customer accounts, and no one at MF Global could or would reverse the check entries. The manager has had to intervene to get MF Global to correct this, and still hasn't gotten the entries corrected. *Reuters's* Matthew Goldstein reported more in "[MF Global and the Rubber Check](#)."

I thought that was bad enough, but on November 10 I was a guest on [Stocks & Jocks](#), a Chicago radio show, when Jon Najarian said that a large broker he knows got a \$400,000 electronic check from MF Global the Friday before that bankruptcy, and the check cleared. If that's accurate, MF Global treated some customers differently than others. [Note: On December 23, 2011, Jon Najarian clarified that the check didn't clear; "it bounced higher than the Willis Tower."]

### **Tip-Offs for Some Customers?**

In August, customers started pulling billions of dollars out of their segregated accounts with MF Global. It was the [biggest outflow of funds since January 2009](#). The bankruptcy trustee may clawback transfers of funds from MF Global as it was teetering, because it is likely that employees within MF Global were well aware of the problems and tipped off key customers.

Yet Gary Gensler, head of the CFTC, did not investigate or begin transferring accounts out of MF Global before the bankruptcy, and that is unprecedented for the CFTC. Given that Gary Gensler was a protégé of Jon Corzine at Goldman Sachs, one should question why Gary Gensler didn't act and why he should be allowed to remain head of the CFTC.

### **CFTC's Gary Gensler Didn't Act**

Gary Gensler, Jon Corzine's former Goldman Sachs colleague and current head of the Commodities Futures Trading Commission (CFTC), had reason to be concerned about MF Global's risk management. In early 2008, a rogue trader racked up [\\$141.5 million in losses](#) in unauthorized trades that exceeded his trading limits. It seems he accomplished this in under seven hours. In August of this year, MF Global and the underwriters of its 2007 initial public stock offering (IPO) agreed to pay around [\\$90 million to settle claims](#) by investors that they were misled about MF Global's risk management prior to the rogue trader's actions. Since 2008, MF Global's financial condition has been nothing to brag about. Now the settlement is in jeopardy due to the bankruptcy. [Michael Stockman, the chief risk officer of MF Global as of January 2011 (after the previous mentioned incident) was in my *Liar's Poker* training class lampooned by another classmate, Michael Lewis.]

In the past, the exchanges and CFTC "always" moved customer positions before a Futures Commission Merchant (FCM) declared bankruptcy. The CFTC had ample reason to have contingency plans for MF Global based on publicly available information. Yet the Gensler-led CFTC hasn't followed this historical precedent when an FCM led by his former Goldman colleague teetered on the edge of bankruptcy. [Gensler has recused himself](#) from the CFTC's probe of MF Global.

The exchange-traded futures markets have been shaken to the core. The Bankruptcy Code apparently conflicts with the Commodity Exchange Act, so customers of MF Global have less protection than one might expect. The Securities Investor Protection Corporation (SIPC) is not the FDIC. Account holders have no idea how long it will take to get back all of their money, if it is there to be recovered, and right now, it appears a lot of it cannot be found. This is why many traders sweep all of the excess cash out of their accounts each day, and only put in cash when required.

### **MF Global Debacle Damages a Key Global Market**

The “risk wizards” of Goldman Sachs once again look like market wrecking balls. The futures market is a globally connected market and it is a key mechanism for farmers, metals miners, and metals fabricators (among others) to hedge their risk. Confidence in the futures market has been shaken. No one knows if their money is safe, but what is more disturbing is the appearance of crony capitalism once again giving favored treatment, lax regulation, and absent oversight to a crony capitalist that abused all of these perks to blow up a large financial firm and damage a key global market.



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financial meltdown.

#### **Other Important Disclosures**

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