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Statement of the Shadow Financial Regulatory Committee on  
**Some Lessons from the MF Global Debacle**

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The surprising “disappearance” of as much as \$1.6 billion in customer funds during the collapse of MF Global has raised questions about the workings and integrity of key aspects of our financial system. At the broadest level the central issue is whether sufficient safeguards exist to protect the integrity of the system and customer funds from undisclosed risk-taking. The collapse of MF Global raises important questions about our financial system, including the effectiveness of the rules for segregating customer funds and the absence of insurance arrangements, monitoring of firms’ internal controls, and the organization and effectiveness of firms’ risk management structures.

While the Securities Investor Protection Corporation (SIPC) protects equity account customers against fraud, futures customers lack protection against the disappearance of their funds in futures accounts. The events last fall suggest that additional protections for futures accounts are needed to enforce the segregation of customer funds and that an insurance fund might be a useful way to protect customer resources. Despite the traditional “segregation” of customer funds from the firm’s funds, since 2005 futures brokers have been permitted to deploy customer funds under Commodities and Futures Trading Commission (CFTC) rules. Indeed, MF Global’s collapse highlights the danger of allowing a broker to use customer money for internal funding and underscores a significant conflict of interest that had been present in our system. Addressing this conflict had been delayed by the CFTC for more than a year until the CFTC acted in the aftermath of the collapse of the MF Global. Ideally, the collapse of MF Global would not have entailed the disappearance of significant customer resources. This suggests that strict segregation of customer funds from the broker’s resources should be required, perhaps using distinct asset titles that would preclude any potential for

misappropriation of these assets. Indeed, the absence of strict segregation would highlight the need for a more explicit mechanism (such as insurance) to protect futures customers.

One of the most disturbing aspects that emerged in the aftermath of MF Global's collapse was that customer losses were present on an overnight basis during the firm's last several days prior to its bankruptcy filing. This raises questions about the possible absence of effective controls and monitoring within the firm. One of the centerpieces of Sarbanes-Oxley (2002) was the periodic certification by management and auditors of the absence of material weaknesses in internal controls. The emergence of customer losses on an overnight basis raises questions about how these could have arisen given the absence of material weaknesses in internal controls that had been attested.

A second important failure in governance that MF Global illustrates is the necessity of enforcing risk management controls within a trading firm. Risk management should be accorded the highest priority by a trading firm. Yet at MF Global, the Chief Executive Officer appears to have bypassed risk controls to make major trading decisions. Traders should be reporting upward and not themselves controlling the risk management function.

Recent events also highlight the difficulty in managing exposures through our global financial system. In particular, in the event of failure there are huge difficulties of obtaining a claw-back when there is international jurisdiction. Indeed, this was an important issue to have emerged in the aftermath of the collapse of Lehman Brothers in September 2008, but unfortunately one in which there has been an absence of apparent progress. Indeed, the trustee seeking funds for MF Global's customers, James W. Giddens, currently believes that \$700 million of the anticipated \$1.6 billion in customer losses reflect funds that are based in London, customer claims to which would be governed by a different legal framework.