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MF Global: Uncertain futures

By Hal Weitzman and Gregory Meyer

The question is how can regulation now be tightened

David Kasouf did not feel like celebrating over the festive season. The 32-year-old independent futures trader from Long Island is one of the 36,000 former customers of MF Global whose money is yet to be returned to them in full.

Almost three months after the spectacular collapse of the broker-dealer, former customers such as Mr Kasouf, as well as farmers, grain transporters and small manufacturers, are still waiting to find out the whereabouts of $1.2bn in missing funds. Until regulators and investigators discover what happened, more than a quarter of the money once held in MF Global customer accounts will remain frozen.

People such as Mr Kasouf increasingly feel they will never get their money back. As Christmas approached, with a wife and two children to support, he considered selling his house or declaring bankruptcy. Ultimately, the 72 per cent of his funds MF Global's bankruptcy trustee has since returned prevented this, but his view of the markets has been shaken. “This has practically destroyed my trust in the whole system,” he says.

Since MF Global filed for bankruptcy on October 31 and revealed that customer money was missing, attention has been focused on Jon Corzine, the firm’s former chief executive. Once a Wall Street “master of the universe”, with a career including stints as head of Goldman Sachs, a US senator and governor of New Jersey, Mr Corzine is now one of the most reviled figures in finance.

There has also been intense scrutiny of CME Group, America’s biggest futures exchange operator and the industry body responsible for regulating MF Global’s commodities business. Some customers are angry at what they say was a lapse in oversight; others say a for-profit entity should not be regulating its own customers. CME responds that no watchdog can guarantee against fraud.

But the MF Global scandal is more than just a question of tarnished reputations. It has had a profound effect on the entire financial industry. The realisation that customers could lose money kept in segregated accounts separate from the firm’s own money – thought by many to be as safe as a bank – has severely damaged confidence in the 163-year-old US futures market. Before the financial crisis, futures were among the fastest-growing of all exchange-traded products.

“This is unprecedented. It’s the single biggest blow the industry has ever had to its business and credibility,” says a former senior CME executive. “It has forced us to ask the question: is the model of the futures industry so flawed that it can never be the same again?”

Such soul-searching is rare for a business that in the past 30 years has transformed itself from an agricultural backwater. Futures markets – which enable producers such as manufacturers to fix for the longer term the prices at which they buy or sell rather than expose themselves to the risk of volatility on the daily spot markets – were once seen chiefly as a system of crop insurance for farmers. Today investors trade agreements to buy and sell in the future anything from oil to financial products.

The sector is proud to have made itself a central element of global financial institutions’ risk-management strategies. CME, once a member-owned trading club, is now one of the world’s most powerful exchange groups. The MF

Global debacle threatens to undermine those achievements. The most obvious indication of the loss of trust in the industry is a fall in futures trading volumes since the collapse of MF Global, which was a dominant force in Chicago's agricultural trading markets and the largest broker on the New York Mercantile Exchange, an energy-trading venue also owned by Chicago-based CME. Most observers say the effect ofMF Global's collapse is the primary explanation.

The impact has reverberated across the industry. "Even brokers who didn't necessarily have their accounts at MF Global are seeing incredible trepidation, especially from international market participants," says Christine Cochran of the Commodity Markets Council, a Washington industry group whose members include big agricultural traders such as Archer Daniels Midland, food companies such as Kraft, hedge funds and futures brokers. "They will pull their money out every night ... It remains to be seen if that trust can be repaired."

At groups such as Scoular, which handles grain at 58 silo complexes in North America, risk managers are rethinking how to insure against price fluctuations. "The industry felt using the commodity exchanges was a way to transfer risk without having to worry about counterparty risk [that trading partners would go bankrupt]," says Bob Ludington, Scoular's chief operating officer. "When the MF Global situation happened, that really woke everybody up. They said: 'Wait a minute, there is counterparty risk.' Then the question is, who do you do business with?"

Regulators have viewed futures as a model for reforming the vast markets in swaps – derivatives that are privately negotiated rather than traded on exchanges – such as the credit default swaps made infamous by the financial crisis. But the collapse of MF Global has prompted some grain merchants to move in the opposite direction. Scoular, for example, is buying from big banks more agricultural swaps, where physical delivery of the underlying commodity is not required. Unlike futures, these derivatives are not "cleared", or protected against the risk of default by an exchange clearing house. "It's basically taking bank counterparty risk as opposed to [futures broker] counterparty risk," says Mr Ludington.

Before MF Global fell, CME often touted the fact that no customer had lost money as a result of a clearing member default. Futures brokers reiterated that claim, leading customers to leave plentiful money in their accounts to cover margin calls – increases in the deposit traders must leave at the exchange clearing house to indicate good faith in fulfilling their contracts. Indeed, futures brokers depend on this, making their profits by reinvesting excess capital and receiving interest on the investments.

As it turns out, unlike bank deposits, futures trading accounts are uninsured by the federal government. And there is no industry body akin to the Securities Investor Protection Corporation, which has a reserve covering securities customers for up to $500,000, to help clients of failed futures brokers.

In the wake of MF Global's collapse, traders are scrutinising brokers more closely. However, the Commodity Futures Trading Commission, the Washington futures watchdog, this week said 70 firms subject to an emergency spot check were compliant.

"People are really evaluating, who am I doing business with?" says Scott Cordes, president of Country Hedging, a Minneapolis-based futures broker. The lack of trust, he adds, could prompt clients to take their chances in spot markets. "If we can't restore the integrity back in the marketplace, long term I think you'll have people taking on more risk than they should be. They might not be hedging."

Since the missing money was held in MF Global's own accounts, CME is not legally obliged to make up the shortfall in customers' funds. Had this happened before CME became a public company a decade ago, its members might well have clubbed together to bail out its traders. Now, its shareholders would be loath to do so.

CME did offer a guarantee of $550m to encourage the bankruptcy trustee to release more frozen funds. That has not, however, stopped calls for CME to come up with all the money itself.

Yet even if the money is found or replaced, it is far from clear confidence can be rebuilt without a change in oversight. "The damage has been done," says John Lothian, who runs MarketsWiki, an industry website. "There are some structural issues that need to be addressed – bankruptcy, self-regulation – and they will be."

The affair has already spurred changes. Last month the CFTC revived a rule limiting brokers' investment options for customer cash. On January 11, as it passed new rules imposing stricter protection for big traders that use cleared swaps, it said it might consider similar safeguards for futures.

Self-regulatory bodies including CME and the National Futures Association are working on possible rule changes for customer funds. The Futures Industry Association, which represents brokers, has set up a task force to suggest reforms.

CME's role as a designated self-regulatory body is under intensifying scrutiny. Barney Frank, the congressman who spearheaded the overhaul of financial regulation, has suggested stripping it of this function. "How did the government allow a for-profit company to have such major regulatory authority?" asks the head of one Chicago futures broker. "It would certainly appear that there's a conflict of interest there."

CME demurs. "The self-regulatory model is really a misnomer for a complex system of organisations that work together to ensure effective regulation," says Anita Liskey, a CME spokeswoman. "It is a proven system that has withstood the test of time. For over 75 years, customers have lost money due to a shortfall in their segregated accounts only once, and that was due to a firm's actions in violations of law. That record compares very favourably to alternative approaches."

CME argues that because it guarantees trades, it has a vested interest in ensuring firms are fully compliant. It also says it has the expertise to do so and notes that self-regulation does not cost taxpayers. It employs 200 auditors and regulators, at an annual cost of $40m, to carry out its duties.

Brokers, too, face further scrutiny. "CME, along with the industry, is exploring additional protections for customer collateral held at the firm-level," says Ms Liskey. "That is where the failure occurred, not at the clearing house, and that is where we and others in the industry believe we need to focus."

The debate has gone further, however, with some questioning the very structure that allows brokers to make profits. "The model has always been that you hold the customers' cash, you invest it and keep the interest," the former CME executive notes. "It's the customers' money – why shouldn't they keep the interest?"

Already, changes made by the CFTC threaten brokers' business model. Limiting their investment options will cut a crucial source of revenue. Fees might be increased as a result, which could put off retail investors.

Ultimately, a quick fix looks unlikely. "Trust has been completely shaken and it'll be a long, slow, hard climb back," says the futures broker's head. "When farmers and small-town banks don't trust us, we need to take a long look in the mirror."

Scandals and losses of speculators past

MF Global's fall is a fresh embarrassment for an industry that has worked hard to disown a history of scandal, *writes Gregory Meyer*.

Since the US futures markets were founded in the 19th century, many scandals have involved "corners" – buying up large quantities of a commodity to drive up the price. In 1888 Benjamin Hutchinson, known as Old Hutch, amassed wheat supplies and shipped them out of town in order to corner the Chicago futures market, according to a book on futures by Robert Kolb and James Overdahl. The resulting scarcity meant traders who had agreed to deliver the grain to him and other buyers at a lower price found it extremely costly if not impossible to honour their contracts. Some reportedly killed themselves in the face of financial ruin.

In the 20th century's most notorious corner, the Hunt brothers tried to gain control of the silver futures market in 1979-80, more than quintupling the price. This unleashed a flood of scrap silverware into the market – which, combined with the intervention of regulators, deflated the bubble.

With the advent of financial futures in markets from interest rates to currencies, the industry has attracted a broader clientele, from Wall Street banks to pension funds. "It had much more of a Wild West feel, with many larger-than-life characters, prior to the 1980s," says Professor Craig Pirrong of the University of Houston.

Still, in 1985 the fall of the Volume Investors brokerage over a gold trade cost customers money. In 1998 the bankruptcy of Griffin Trading, a Chicago-based futures firm, caused big losses to traders in London, driving several out of business.

“The futures industry has worked very hard for decades to overcome that stigma and image of itself,” says Emily Lambert, author of *The Futures*, a market history.