



# Post MF Global

A recap of the firm's collapse, the discovery of missing funds and the bankruptcy filing that shook the futures industry to its core

By Diana Klemme

**N**obody likes to lose money — least of all when it occurs in a system long considered safe. Regulators, exchanges, futures firms, and individual brokers have all taken pride and advertised that futures customer funds are segregated from any monies or positions of the clearing member holding

customer funds. As CME Clearing's Financial Safeguards document states: "The (segregation) regulations are designed to protect customers in the event of insolvency or financial instability of the clearing member through which they conduct business. CME Group's Audit Department routinely inspects the books and records of the clearing members

book of accounts, positions and funds were typically transferred intact to another firm or firms that seamlessly integrated that business. "Business as usual" had been the mantra in the past; customers were literally segregated from the financial losses of the firm that had held their account(s).

Then came October 31. The collapse of MF Global and the discovery that something in excess of \$1 billion of customer segregated funds were unaccounted for in the final days before the MF Global bankruptcy filing shook the futures industry to its core. MF Global's demise



**Diana Klemme** is a longtime contributor to *Feed & Grain*. Contact her at Grain Service Corporation, Atlanta, GA, by calling (800) 845-7103 or e-mail at [diana@grainservice.com](mailto:diana@grainservice.com).

to ensure among other things, their compliance with segregation requirements." Prior failures of Futures Commission Merchant firms posed little to no disruption to the firm's futures customers — the entire

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wasn't just about one firm's failure; this exposed systemic weaknesses in these regulations and laws governing the protection of customer funds held in *all* futures and options accounts at *all* firms. Customers and brokers alike discovered that the "letter of the law" and the perceived

customer protections were quite different. Some accounts found their positions transferred to other firms by Nov. 4, while other accounts remained at MF Global which was no longer able to handle transactions. But much of the customer segregated funds, including Treasury

Bills, remained either missing or seemingly in 'limbo.'

MF Global became mired in both an S.I.P.A. liquidation and the eighth largest bankruptcy in the U.S. (bigger than Chrysler). The actions are governed under separate laws and regulations, and encompass 38,000 futures customers (and 400 securities accounts) from London to Los Angeles. The SIPA Securities & Investors Protection Act liquidation is overseen by Trustee James Giddens, with the Chapter 11 reorganization of MF Global Holdings



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overseen by Trustee Louis Freeh. The end result has been a legal tug of war, crossing continents and jurisdictions with customers caught in the crossfire at times. It wasn't until mid-December, and after three transfers of cash, that customers had a reasonably complete record of movement of their funds to date. Approximately 72% of customers' account balances have been returned with the remainder showing as an unrecovered asset and a claim against MF Global. Even by mid-January, the remaining dollars have not officially been located, let alone recovered.

Bankruptcies aren't resolved quickly, and there's reason to hope more customer dollars will be recovered, or that other resources may assist in covering customer losses. But the core issue remains:

How could this happen and what's being done to ensure it doesn't happen again?

The weakness in the system is that the protections are sufficient, but only if an FCM does not remove customer segregated funds for any purpose other than those allowed for under law. For instance, FCMs may hold and invest Seg Funds in certain instruments authorized under CFTC regulations, with the interest earnings accruing to the FCM. If an FCM fails but all Seg Funds are held as required, regulators can quickly "sell" and move the accounts and funds to other firm(s). But it came to light there is no insurance coverage nor other protections against outright shortfalls in customer Seg Fund balances.

Customers are furious, Congress is up in arms, and lenders are reviewing their potential exposure in providing margin monies to fund hedge accounts. Hearings are important to get at the bottom of what happened and to hold accountable those who may have done wrong. But equally urgent is changing the system to protect customer funds. The safety of customer collateral — including your working capital and the margin money *your* lenders send to Chicago or KC or Minneapolis — has been what has allowed agriculture to offer the wide array of marketing alternatives to farmers, and to rapidly and easily trade cash grain among commercial firms with pricing via exchange of futures. If lenders are reluctant or won't completely fund margin requirements, borrowers will have to reassess how far forward they'll buy grain. Everyone recalls the margin demands the industry faced in 2008 and again in 2011 as prices skyrocketed!

Rapid change is essential and CFTC Commissioner Bart Chilton summed it up well in the introduction to his Jan. 11 statement to that day's commission hearing on swaps regulations: "When things go wrong

... for so many years, we had the confidence that customer funds were so very well protected by the federal commodities segregated account statutes and regulations. But MF Global was a stone-cold, Sumatrabold, no-holds barred wake-up call — this was a hit to the very heart of

who we are as regulators and who we are as an industry."

## Now the hard work is underway

The CFTC just finalized customer collateral protection regulations for swaps customers as required under



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Dodd-Frank legislation. Trillions of dollars of swaps business will be moving to clearing on exchanges in the years ahead, and swaps customers are equally concerned about their collateral. CFTC adopted an LSOC regulation: “Legally Segregated, Operationally Commingled,” where all customer funds are commingled but accounted for individually, the same as for futures and options. But there are some differences in how swaps funds would be handled in a bankruptcy situation. The key to the protections is what might constitute “Legally Segregated.” In private-over-the-counter swaps, for example, some big participants demand their dollars be held in a third-party bank of their choice for extra security. That is not an option under LSOC.

### Brave new world

In a Post-MF Global world for both futures and swaps, “Legally Segregated” might involve the creation of an entirely new model, such as a Central Depository, that would receive and hold all funds for all customers — entirely separate from the futures firms. Customers of Abracadabra Futures, in that case, would wire funds to the C.D. — not to Abracadabra’s bank. Or a Central Depository might actually be an existing bank, but one that handles no “house accounts” for any futures firm, does no proprietary trading, and in no way would put customer Segregated Funds at risk. Any earnings on such Seg Funds would likely be managed by the CD and divided proportionally among all of the futures firms whose clients’ funds are deposited.

Another previously unrecognized risk facing both futures and swaps customers is outlined in confusing verbiage covering the event of a default by a customer which in turn triggers a default by a Clearing Member to the CME: “...if a default occurred in either segregated accounts or customer

secured accounts, CME Clearing has the right to apply all performance bond deposits; performance bond deposits and positions deposited by customers not causing the default are potentially at risk.” In plain English, if MF Global had not been able to meet margin calls at CME because an MF Global customer failed to meet their obligation, CME could come back to other customers.

The Devil’s always in the details, and any dramatic overhaul will require regulatory change at the CFTC level, and perhaps legislative change. And for every risk that’s eliminated another may be found that has to be tackled. Insuring customer funds sounds like an easy solution, e.g. skeptics counter that raises “moral hazards.” But a lot of people are already hard at work behind the scenes, swapping ideas and finding the weaknesses as well as the strengths, to quickly craft a better system so agriculture can get back to the business of managing risk and feeding the world.

You can help by writing or calling your representatives and senators, and writing or emailing the CFTC, telling them that your willingness and ability to use futures and options, and your lenders’ willingness to finance hedging, depend on your money being safe — regardless of what firm you deal with.

### YOU CAN HELP

For names and postal or email addresses:

- U.S. Senate – Committee on Agriculture, Nutrition and Forestry: <http://www.agriculture.senate.gov/>
- U.S. House of Representatives – Committee on Financial Services: <http://financialservices.house.gov/>
- CFTC: <http://www.cftc.gov/About/Commissioners/index.htm>