



MANY VOICES, ONE VISION

FARM BUREAU®—CONFRONTING THE ISSUES

Futures Market Policy Development 2012

Issue:

From their inception in the mid-19th century, futures markets have functioned as an important tool for agricultural producers to transfer their price risk to other investors. Over the years, futures markets have become inextricably intertwined with other marketing institutions. For example, forward contract offerings are invariably based on quoted futures prices. Similarly, price guarantees on crop insurance products are derived from prices established on the futures market. Thus, futures markets not only allow one means of transferring risk, they inform all agricultural marketing arrangements and influence price discovery in all other related markets. Their role in the agricultural economy is difficult to overstate.

On October 31, 2011, the cash and derivatives broker/dealer firm MF Global (MFG) filed for Chapter 11 bankruptcy protection. With the bankruptcy filing, MF Global account holders were surprised to find that the assets in their trading accounts had been frozen. This included the accounts of a large number of hedgers of agricultural commodities: farmers, ranchers, cooperatives, and other downstream agribusiness firms such as grain elevators and feedlots. Currently, most of these account holders are still missing about 25 percent of their assets. That segregated trading account balances could be lost—not through normal trading activity but through bankruptcy proceedings on the part of the trader's broker—was a major shock to many hedgers. This episode has undermined confidence in futures markets generally. If futures markets are going to continue to function as a useful means of managing price risk in agriculture, meaningful steps to restore that confidence are required.

Background:

The causes of the collapse of MFG are, almost six months after the fact, still not entirely clear. Available evidence suggests that the firm entered into large, highly leveraged positions on European sovereign debt. As the price of European bonds fell, MFG's positions lost money. As this exposure became apparent, rating agencies downgraded MFG's credit rating, raising their borrowing costs at the same time that their trading positions were losing money. Ultimately, MFG was unable to raise the funds necessary to meet margin calls on its open positions and was consequently forced into bankruptcy.

The most vexing question related to MFG is not how they went bankrupt. In recent years, there have been numerous examples of financial firms driven to bankruptcy by highly-leveraged trading (with Lehman Brothers being probably the most prominent example). The difficult question is what happened to missing customer funds that were supposed to be strictly segregated from MFG's own proprietary trading funds? Immediately prior to the bankruptcy filing, MFG accounting showed a nearly \$1 billion shortfall in its customer accounts. Currently, the bankruptcy trustee managing the case estimates that identifiable assets are about \$1.6 billion short of covering all claims. About \$200 million in what were supposed to be segregated customer funds were found to have been transferred to cover an overdraft with JP Morgan. What accounts for the rest of the shortfall is unclear.

It is important to note that FCMs such as MFG are allowed to use customer funds within prescribed limits: they do not have to hold 100 percent of customer funds in reserve with no yield. These funds can be invested in what are considered essentially risk-free instruments (e.g., Treasury bills). Excess reserves in customer accounts can also be rehypothecated (i.e., essentially used as collateral) by the FCM to fund other activities. Notably, MFG account agreements allowed the firm to transfer customer funds to its British subsidiary, operating under the United Kingdom's more permissive rules for the handling of customer funds. In the fine print of agreements MFG customers signed, it explicitly authorized MFG to use customer money for this kind of activity. This ability to make use of customer funds may help explain how MFG found the resources to fund its aggressive proprietary trading, but it

does not explain where the customer money actually went. MFG was still required to account for the segregated funds and, in the case of rehypothecation, to pledge assets equivalent to customer fund balances.

With so many questions unanswered about the MFG debacle, it is no wonder that this episode has undermined confidence in futures markets more generally. Many traders, including hedgers, felt that the exchange would guarantee the integrity of their accounts. This is not the case. The exchange, through its clearinghouse, guarantees the integrity of each transaction. In a trade cleared by the exchange, you do not have to worry that the counter-party to the trade will renege on his or her obligation. But that is not the same thing as guaranteeing that the full balance of a trading account with an FCM will be insured.

Moving forward, the key question is what safeguards can be put in place—either through futures exchanges, through the Commodity Futures Trading Commission (CFTC), or through some other organization—to protect futures market participants from events like this in the future? CME group has already moved to establish a \$100 million fund to compensate farmer/rancher hedgers in the event of another MFG-type event. (The fund does not operate retroactively.) This fund would compensate hedgers up to \$25,000 per account in the event of a loss. An alternative means of dealing with brokerage losses already exists in the securities (stocks) field, where the Securities Investor Protection Corporation (SIPC) has existed since 1970 specifically to indemnify investors for funds missing from customer accounts in the event of a brokerage firm bankruptcy. It is possible that the SIPC model could be cost prohibitive when extended to commodity trading, where higher levels of leverage can greatly magnify losses; however, it is a model with a proven record of investor protection. The CME Group has also required daily reporting of segregated funds, effective May 1, 2012.

Questions:

1. Is it feasible to impose limits on leverage for the proprietary trading of brokerage firms, and if so, how should appropriate risk ratios be determined? Should the amount of leverage be required information to be made available to customers?
2. Are new or additional limits needed to regulate the type of financial instruments allowed for the investment of funds held in segregated accounts?
3. Could bankruptcy laws for futures commission merchants (FCMs) like MF Global be changed to afford more protection for customer funds (e.g., making sure that brokerage customers remain first in line in bankruptcy proceedings when their funds have been pledged as collateral to other creditors)?
4. Would additional (more complete and/or more frequent) reporting on segregated fund balances provide any additional protection to traders or would it simply raise costs and complexity for exchanges and for brokerage firms?
5. How can meaningful protection for customers be offered when multinational firms can transfer funds to foreign affiliates where another country's bankruptcy laws may take precedence?
6. Could an entity analogous to the Securities Investor Protection Corporation (SIPC) be formed to indemnify investors in the event of an FCM bankruptcy? Are there other types of insurance programs that should be considered to indemnify any losses of segregated funds? Would the cost of insurance outweigh the benefit of guaranteed protection in the event of a loss?
7. Should FCMs be required to use wire transfer of funds to prevent firms from using paper checks to slow the distribution of funds in a situation of financial stress?

Farm Bureau Policy:

221 - Commodity Futures and Options. Farm Bureau's general philosophy on these markets is summarized in the following lines:

Lines 1-3: The integrity of all U.S. commodity futures and options exchanges as a pricing mechanism must be maintained by the members of the exchanges and their overseeing governing bodies ...

Lines 6-10: Commodity futures and options trading serves a useful purpose for a number of commodities by providing a means to transfer certain types of risk. ... We urge that regulatory laws be strictly enforced.