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Protecting Futures Customers from Brokerage Firm Failures, Part 4

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February 26, 2014

***farmdoc daily* (4):36**

Recommended citation format: Peterson, P. "Protecting Futures Customers from Brokerage Firm Failures, Part 4." *farmdoc daily* (4):36, Department of Agricultural and Consumer Economics, University of Illinois at Urbana-Champaign, February 26, 2014.

Permalink:
http://farmdocdaily.illinois.edu/2014/02/protecting-futures-customers-brokerage-failures-part4.html

Earlier articles (*farmdoc daily* January 15, 2014, January 24, 2014 and February 5, 2014) examined the feasibility of various protection proposals for futures customers and reviewed new CFTC regulations to reduce fellow-customer risk. Today's post concludes this series with a look at other mechanisms to protect customer funds from a brokerage firm failure.

Stricter Regulation

Throughout this process, there has been no shortage of ideas on how to fix the current system of protecting customers from brokerage firm failures. Many have involved some form of stiffer regulations on brokerage firms, beyond the new regulations already imposed by the CFTC. Supporters have pointed out - correctly - that customer funds belong to customers, and should never be at risk to misuse. One such proposal suggests that clearinghouses should hold all customer funds, so that these funds are out of the reach of the brokerage firms. However, many customers trade at multiple exchanges, and there is no mechanism to transfer or coordinate customer funds across multiple clearinghouses.

Tighter regulation also carries the risk that responsible firms and their customers would be punished, in the form of higher costs, for the misdeeds of a handful of bad actors. These bad actors don't follow the current rules, as evidenced by MF Global and Peregrine Financial/PFG Best, so there is no reason to believe they would be any more diligent in following any new, stricter rules.

Voluntary Insurance

Mandatory insurance on all customer accounts appears to be unworkable for a number of reasons, but there may be enough interest to support a voluntary insurance program. The Compass Lexecon study, discussed in our second post, indicated that a group of insurers contacted during the study was interested in developing and offering voluntary coverage; a futures customer group later endorsed this idea. With a voluntary program, those who want coverage would be the ones who pay for it. Readers may recall that a mandatory program would impose a financial burden on everyone in the industry, and could lead to further consolidation of the already-small number of futures brokerages. It will be interesting to see whether a voluntary insurance program comes to market and how it is received by customers.

Yet another proposal would create a program that would immediately step into customers' shoes whenever a firm fails and provide them with the full amount of customer funds stranded at the failed firm. Customers would be able to continue hedging and trading without any interruptions. Meanwhile, the program would assume and pursue all (former) customer claims and recover those funds over time as the bankruptcy process unfolds. Recovered funds would be deposited back into the program for use against future claims, similar to the process used by SIPC. The biggest hurdle would be to set up an initial pool of funds that could be used for customer claims. However, supporters believe the initial pool could be created by issuing debt, which would be backed by a fee of a few cents on each transaction. Unlike SIPC, no government funding would be needed, either to establish the program or to keep it running.

MF Global vs. PFG Best

Recent statements by the bankruptcy trustee that MF Global customers eventually will receive 100 cents on the dollar might lead some to wonder whether anything really needs to be done to change the current system. This view overlooks the fact that MF Global customers have been waiting two-plus years for their money, and during that period their trading activities have been severely disrupted.

It also ignores the situation faced by customers of PFG Best, which collapsed in July 2012 as the result of a long-running fraud by the company's owner. Approximately $215 million in customer funds went missing at PFG Best, a small fraction of the amount in the MF Global case. But unlike MF Global, PFG Best did not have much in the way of other assets that could be used to pay customer claims. Consequently, US customers of PFG Best so far have recovered just 37% of their missing funds, and are unlikely to ever receive full payment. Last week, the PFG Best bankruptcy trustee requested permission to meet with Russ Wasendorf Sr., the founder and former CEO of PFG Best (who confessed and was sentenced to 50 years in prison), in hopes of finding out where the money went.

Déjà Vu All Over Again?

In the late 1970s, a wave of brokerage firm failures rocked the futures industry, leading to a serious examination of the way business was conducted and prompting a number of proposals for ways to better protect customers. But as time passed, customers were repaid, and no additional failures occurred, the sense of urgency was lost. Interest in making industry-wide changes faded away, and the underlying problems were left unaddressed.

Fast forward to 2014. More than two years after the industry suffered two back-to-back brokerage firm failures - one of them the eighth-largest bankruptcy of all time - nothing much has changed, and the sense of urgency has largely disappeared except among those customers still waiting to recover their missing funds. There are numerous proposals on the table, several of which have been described in these posts, and like all proposals each has its own strengths and weaknesses. It remains to be seen whether the opportunity to fix this issue slips away once again, and the problem is allowed to resurface at some point in the future.

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