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Customer Accounts and the MF Global Bankruptcy

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MF Global failed on October 31, 2011, producing the eighth-largest bankruptcy in US history and the largest commodity brokerage collapse of all time. While this is not the first time a major brokerage firm has failed, what sets MF Global apart is the fact that $1.2 billion in customer funds were missing at the time of the failure, and still remain missing three months later. This shortfall affects approximately 38,000 futures brokerage accounts, a large percentage of which were held by individuals and entities in the agricultural sector.

The Commodity Exchange Act and Commodity Futures Trading Commission (CFTC) regulations require funds in customer futures and options brokerage accounts to be segregated from all other money, securities or other property owned or controlled by the brokerage firm. The funds from all customers can be commingled in a single account, but they must be separately accounted for, and must be treated as belonging to the customer.

These segregated funds may be invested in US government securities, US agency obligations, municipal securities, certificates of deposit issued by Federal Deposit Insurance Corporation-insured banks, commercial paper and corporate notes or bonds guaranteed by the federal government’s Temporary Liquidity Guarantee Program, or money market mutual funds. Effective February 17, customer funds can no longer be invested in sovereign debt, due in large part to concerns about the creditworthiness of a number of foreign countries. In addition, there will be new limits on the percentages that can be invested in certain of these categories in an effort to encourage diversification.

The reason why customer funds are segregated is to put them out of reach and prevent them from being diverted to other uses by the brokerage firm. Similarly, the investment restrictions on segregated funds are designed to ensure that they are not exposed to loss from poor or risky investments. Many observers have described segregated funds as "sacrosanct," never to be touched by the brokerage firm entrusted with those funds for anything except meeting margin calls or other financial obligations of the customers who own those funds. Any other use of segregated funds is a violation of both the Commodity Exchange Act and CFTC regulations. Exactly what happened at MF Global – whether the firm tapped the segregated funds account to meet its own financial needs, or the funds were improperly invested in financial instruments that suffered steep losses, or any of the other possible explanations being pursued by investigators – is still an open question. However, the fact that these funds are missing has caused severe financial distress for former MF Global customers.

The Federal Bankruptcy Code, the Commodity Exchange Act and CFTC regulations all recognize the important status of segregated funds, and grant special treatment to futures/options brokerage accounts held by public customers. When a bankruptcy occurs, all customer accounts of that brokerage firm are to be transferred in their entirety, including all assets specifically identified with a particular customer account. Any assets that remain after these customer accounts have been transferred – including assets in accounts owned or controlled by the brokerage firm, such as "proprietary" and "house" trading accounts – are then to be liquidated and divided among the remaining creditors, along with any other assets owned by the firm.

The normal procedure is that customer accounts – including futures and options positions, cash balances and securities posted for margin, physical commodities used for the purpose of making or taking delivery, warehouse receipts, and all other assets specifically identified with a particular account – are moved to one or more other brokerage firms, in a process referred to as a "bulk transfer." This bulk transfer process is quick and seamless, and is normally completed within a day or two. The only change from the customer standpoint is that his or her account is now located at a different company, much like what happens when a local bank is acquired by another financial institution. In some cases the bulk transfer process has been initiated shortly before the failing brokerage firm files for bankruptcy, which further streamlines the process and minimizes the impact to customers.

In the MF Global situation, a series of bulk transfers of customer positions have been conducted, but because customer funds are missing it has been impossible to transfer these accounts with all the funds they are supposed to hold. The first set of transfers required involved accounts with open futures or options positions and included approximately 60% of the collateral (margin) in those accounts. The second set involved accounts containing only collateral but no open positions, and transferred approximately 60% of the balance in each account. The third round of bulk transfers brought the balance to approximately 72% for both accounts with open positions and accounts without open positions.

Will former MF Global customers ever see the remaining 28% of their funds? The answer to this question depends in large part on whether the bankruptcy trustee and others are successful in recovering the missing $1.2 billion in customer funds. It also depends on whether the proceeds from the liquidation of any other MF Global assets (mostly cash and securities, estimated by the trustee at $290 million) are applied to the shortfall in customer funds, or instead used to pay other creditors. In a January 18 filing to the bankruptcy court, the CFTC argued that commodity customers must be made whole, even if this requires others to be sent away empty-handed. This and other issues likely will be resolved in the courts, so it may be many months before the final outcome is known.