



Seg Funds Revisited: Industry Response to Peregrine and MF Global Collapses

By Joanne Morrison

The collapse of Peregrine Financial Group in July, coming on the heels of MF Global's collapse last October, has galvanized an industry-wide self-examination.



In both cases, the bankruptcy process revealed a significant shortfall in customer money, something that had never happened before in the history of the U.S. futures industry. The two incidents struck a major blow to confidence in the ability of the industry to properly handle customer funds and raised serious concerns about the effectiveness of the industry's self-regulatory system.

So far, lawmakers in Washington have not attempted to legislate a solution. Instead, the initiative for change has come from within the industry, with a wide range of ideas being talked about as possible solutions. These include electronic verification of customer balances, stronger internal controls, the creation of an insurance fund, the use of third-party custody accounts, and providing customers with more visibility into the handling of customer funds.

Although both collapses revealed weaknesses in the segregation of customer funds, there are important differences in the types of weaknesses they revealed. At Peregrine, it was a case of misappropriation of funds that went undetected by auditors and regulators for years. Russell Wasendorf Sr., the firm's founder, asserted in a note found after his attempted suicide that he had been engaged in an elaborate fraud for nearly 20 years, misleading auditors by forging bank statements and other documents.

At MF Global, it was only when the company was desperately seeking a sale to another futures commission merchant that the shortfall in customer funds was discovered. Regulators and bankruptcy liquidators are still working to pinpoint exactly what led to the shortfall, but according to the bankruptcy trustee, the shortfall was driven by a "perfect storm" of weak internal controls, inadequate systems, disorganized record-keeping, and a desperate need for additional funds to meet margin calls on the firm's proprietary trades.

The Futures Industry Association has been at the forefront of industry responses. In February, it unveiled a number of specific recommendations for tougher internal controls at firms and increased transparency for customer and regulators. Many of these safeguards already have been adopted by the industry and enforced by new rules, but more must be done in the wake of the Peregrine debacle, according to Walt Lukken, the FIA's president and chief executive officer.

"We have two instances in less than a year when segregation was breached and customer funds are missing. That is unacceptable," Lukken told the Senate Agricul-

ture Committee on Aug. 1.

FIA members are now working with other segments of the industry on a series of additional recommendations that will be presented to the Commodity Futures Trading Commission. One important goal is to provide greater transparency into the financial health of futures commission merchants through the disclosure of key metrics such as capital and leverage. Another important recommendation is to build a system that will provide "independent verification" so that customers can be confident that the money in segregated customer accounts is actually there.

While it will take some time to implement these recommendations, no changes to the laws will be needed. Other proposals will require legislation, however. These include changes to the bankruptcy code and the creation of an insurance fund. Although some believe that legislative action could take place before the end of the current session at year-end, others say that any legislative proposals are more likely to be taken up next year, after the elections have taken place.

Regulators Under Fire on Capitol Hill

The House and Senate agriculture committees both recently held hearings to examine the two failures. At both hearings, lawmakers questioned how these failures could have taken place under the watch of regulators. In the case of MF Global, the primary self-regulatory organization was CME Group; in the case of Peregrine, it was the National Futures Association. In both cases, the Commodity Futures Trading Commission was responsible for ensuring that the self-regulatory organizations were doing their jobs properly.

"The question remains, who's minding the store? There are some in this town who would argue that we need more regulations, but the fact remains that new regulations mean nothing when regulators are not enforcing the existing rules on the books," said Representative Frank Lucas (R-Okla.), the chairman of the House Agriculture Committee, at a July 25 hearing.

Democrats expressed similar views, expressing bafflement that the CFTC and the NFA missed the fraudulent activity at Peregrine for two decades even though there was a series of red flags at the firm. "You can have all the books with all the laws in them, but if you don't enforce them, sometimes it is worse than not having them at all," said Senator Amy Klobuchar (D-Minn), who

worked as a county attorney before coming to the Senate.

CFTC Chairman Gary Gensler testified before both committees and outlined the steps being taken to improve the monitoring of futures commission merchants and customer funds held in segregated accounts. The CFTC chairman explained that the self-regulatory organizations are the "front-line" regulators in charge of examining firms and reviewing independent audits while the CFTC's job is to oversee the examination process. Gensler agreed on the importance of getting new protections in place and estimated that they could be implemented over the next few months. "The system clearly failed to protect Peregrine's customers, and I believe we all must do better," Gensler said.

Some lawmakers asked whether the CFTC is focusing too much of its attention and resources on implementing Dodd-Frank regulations. Gensler agreed that his agency is stretched as it moves forward with the large number of rulemakings mandated by the Dodd-Frank Act, but he reassured members that the CFTC is also giving serious attention to the customer protection regime.

This comment was countered, however, by Jill Sommers, the Republican commissioner at the CFTC in charge of the MF Global investigation, who said the agency could be moving faster. "I do believe that we identified many of the enhancements that we could have made to the futures industry six months ago. So the changes that are before us now are changes that we could have implemented months ago," she told the Senate Agriculture Committee on Aug. 1.

FIA Recommendations

Many of the safeguards that are now being adopted by firms and SROs are in line with the initial recommendations released in February by the FIA's Futures Markets Financial Integrity Task Force.

These recommendations called on FCMs to adopt and document internal control policies and procedures relating to the protection of customer funds and maintain a clear separation of duties among individuals responsible for compliance with customer funds segregation. The recommendations also called for enhanced recordkeeping and reporting, including transmitting daily customer segregation balances. The recommendations also require chief financial officers or other senior officers to authorize in writing and promptly notify the designated SRO whenever an FCM seeks to withdraw more than 25% of its excess funds from the

Mark Holloway of Goldman Sachs and Alessandro Cocco of JP Morgan participate in a Roundtable Discussion at the CFTC



customer segregated accounts in any day.

The FIA also released a “frequently asked questions” document prepared by members of the association’s Law and Compliance Division. The document was designed to be used by FCMs to help their customers better understand the provisions of the Commodity Exchange Act and the rules of the Commodity Futures Trading Commission that relate to customer protections. It contains 30 questions and answers addressing the basics of segregation, collateral management and investments, capital requirements and other issues.

The next step came in July, when FIA’s Lukken announced a four-part transparency initiative during a speech to members of the FIA Chicago division. Lukken said the plan calls for providing regulators with the ability to electronically review and confirm customer segregated balances at any FCM at any time. Second, FIA supports creating an automated confirmation process for segregated funds that will provide regulators with timely information that customer funds are secure. Third, FIA is exploring ways to create an “information portal” to centrally house information about FCMs so that customers can better evaluate the financial

condition of their FCM. Fourth, FIA calls on FCMs to publicly certify that they are in compliance with the initial recommendations that the FIA issued in February.

“Many individual firms have already begun to make efforts to implement changes and disclose more information in response to this crisis of confidence, but this effort must be industry-wide and FIA is committed to leading that effort,” Lukken said during the Chicago speech.

Meanwhile the industry’s SROs are moving in parallel to implement a broad range of new rules and requirements. On July 17, the SROs unanimously agreed to immediately begin the process of confirming the balances of customer segregated bank accounts for all FCMs using a web-based electronic confirmation process. Additionally, the SRO committee said it would set rules requiring that all FCMs provide their DSRO with direct online access to the bank accounts that hold the FCM’s customer segregated and secured funds.

“Any bank depository that fails to provide electronic online access will not be considered an acceptable depository for holding customer segregated and secured funds, under the added recommendations,” the NFA

said in a statement.

Also in July, the CFTC approved a set of requirements drafted by the SROs that will tighten internal controls and provide better and more frequent information on the handling of customer funds. These new safeguards include requiring FCMs to file daily segregation and secured reports and bi-monthly reports detailing how customer funds are invested and where they are held, performing more frequent spot checks to monitor FCM compliance, and requiring a principal of an FCM to approve any disbursement that exceeds 25% of “excess funds,” meaning the firm’s own money in customer accounts.

Electronic Access to Segregated Accounts

There is broad agreement among industry representatives that regulators and SROs should have direct electronic access to view customer segregated funds accounts. Implementing this idea may be more complicated than people realize, however.

At a July 26 meeting of the CFTC’s Technology Advisory Committee, panelists cautioned that there are technical challenges in accessing information from certain

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accounts. Accounts at banks and clearinghouses will be the easiest to access, but there are challenges in obtaining information from custodial accounts, they said. There are even more challenges with 30.7 secured accounts holding funds for foreign futures and options because they would have to be verified through foreign affiliates. As a result, it may take more time to build a technology solution that will cover these foreign secured accounts.

Gerry Corcoran, chairman and chief executive officer of R.J. O'Brien & Associates, provided participants with a detailed look at an RJO customer segregated funds statement to illustrate those areas that will be easier to provide verification of funds as well as those areas that will take more time to implement. Corcoran said that RJO has up to 70 different accounts with banks, carrying brokers and exchanges in the U.S. and abroad, and he estimated that industry-wide verification would require access to more than 1,000 accounts.

Chris Hehmeyer, chairman of the board of the National Futures Association, explained that the NFA plans to build a system that will verify account information by the next trading day, commonly known as T+1. While this will not capture every movement of funds in real-time, it should serve as a sufficient deterrent to fraudsters, industry representatives told the CFTC. "It will never be 100% bulletproof, but the knowledge that you will be caught at the end-of-the-day true-up will be a deterrent," said Chuck Vice, president and chief operating officer of IntercontinentalExchange.

Individual Firms Take Action

Even as the industry-wide initiatives are moving forward, individual firms are rolling out their own responses to the concerns raised by the collapses of MF Global and Peregrine.

One example is Citi. The bank, which operates one of the largest FCMs in the world, launched a "transparency portal" in July that gives customers online access to details about how their futures and swaps collateral is invested and where their funds are being held. The transparency portal is within the bank's Velocity platform, which provides a single point of access to Citi's research, analytics, execution and post-trade services.

Christopher Perkins, global head of OTC clearing at Citi, explained that clients can now view the total amount of futures and cleared OTC collateral that Citi is

holding, the custodial locations where the collateral is being held, and a breakdown of how the collateral is being invested. Perkins said that the bank is working on the next phase of the project, which will focus on independently validating the balances held at clearinghouses as well as more frequent updates to the information. He declined to go into detail but commented that the bank views this effort to provide transparency as a key feature of Citi's clearing services.

"It's critically important to have minimum regulatory standards for transparency into the handling of customer funds, but we hope the regulators allow ample room



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WALT LUKKEN, FIA

for FCMs to differentiate themselves and ultimately compete on transparency," said Perkins. "There's a commercial incentive to be more transparent than the next guy."

Rosenthal Collins Group is another example. On July 17, the FCM began posting on its website daily reports describing its investment of customer segregated funds.

"RCG is determined to go above and beyond what is required of us to provide our customers with reassurance that we are investing their funds wisely," said Scott Gordon, the firm's chief executive officer. "Unquestionably, the events of the last 10 months have undermined the confidence of market participants in an industry which serves a vital role in the global economy. While we can't singlehandedly restore that confidence, we can do our part to ensure that customers feel confident in how we

handle their money. We also will continue to find new ways to provide transparency and contribute to industry solutions."

Calls for Insurance

While much of the attention has focused on strengthening existing protections, some have called for more fundamental reforms, such as creating an insurance fund that would protect futures customers in case their FCM fails. One model is the fund managed by the Securities Investor Protection Corporation, which guarantees customer securities investments up to \$500,000 in the event a brokerage firm collapses.

James Giddens, the trustee handling the MF Global bankruptcy, has been a strong proponent of establishing an insurance fund. At the Aug. 1 Senate hearing, he explained that the vast majority of MF Global's customers held relatively small accounts and could have been made whole if an insurance fund had been in place. He also told lawmakers that the process of transferring customer accounts out of a failed FCM would be much smoother if there were such a fund, since it would eliminate the need to hold back some funds to cover a shortfall.

"It's a cumbersome process even to collect funds that demonstrably belong to customers," Giddens said. "Nothing works quite as it is described when you're in a bankruptcy."

Some end-users have supported the insurance idea. For example, the National Grain and Feed Association, a trade group that represents agricultural interests, has proposed making insurance available on an optional basis for any market participant willing to pay for it. Diana Klemme, an agricultural hedging expert who testified on behalf of the NGFA, told the Senate committee that her clients would be willing to pay for insurance through a transaction fee. "My customers would pay for it right now," she told the Senate Agriculture Committee.

The details have not been fleshed out, however. Some have suggested that the best way forward would be to extend SIPC coverage to include futures. Others have called for the formation of a separate fund just for futures. Another key issue is funding; there is no consensus yet on who should pay and how much.

Bart Chilton, a Democratic commissioner at the CFTC who strongly supports the insurance idea, issued a proposal on Aug. 9 with some concrete details. His proposal calls on Congress to create a SIPC-

like insurance fund called the Futures Investor and Customer Protection Corporation with up to \$2.5 billion in assets. The funding would come from a fee paid by FCMs equivalent to 0.5% of annual gross revenues from their futures business. Coverage of loss would be limited to \$250,000 in futures liquidation value and cash.

“By drawing on an existing blueprint, the creation of FICPC would be a relatively simple task for legislators and FICPC administrators,” Chilton said. “This would help remedy the present crisis of confidence in the futures markets in the wake of the fall of Peregrine Financial Group and MF Global.”

The agency’s chairman is more cautious, however. While not rejecting the insurance idea, Gensler has stressed initiatives that can be put into effect without requiring changes to the law. “I think we need to focus in on our rules and ensure ... the self-regulatory function works better,” he told the Senate Agriculture Committee on Aug. 1.

Gensler also is wary of the potential costs, saying that the costs and benefits of establishing an insurance fund would have to be weighed before the idea could be implemented.

An alternative approach would be to create an industry-funded “liquidity facility” that would focus on covering shortfalls in customer property and ensuring that customer accounts are transferred quickly to other brokers. This proposal has been put forward by the Commodity Customer Coalition, a group formed after the collapse of MF Global to represent customers of the failed FCM. The facility in effect would “step into the shoes” of the failed firm’s customers, enter the bankruptcy proceedings in their place, and pursue their claims for recovery of missing funds. In this way the facility would recover whatever funds were used to support the customer account transfer process.

In testimony before the Senate Agriculture Committee on Aug. 1, John Roe, an introducing broker and co-founder of the CCC, explained that there is a Canadian model for this idea. When MF Global collapsed, the Canadian Investor Protection Fund provided a 20% guarantee on the customer property at the firm’s Canadian subsidiary. That covered a 20% shortfall in the customer accounts and cleared the way for the transfer of more than 7,000 accounts of MF Global Canada to new brokers. As a result, he told the committee, “Canada’s commodity customers can still make the claim

that no customer has ever lost a penny as the result of a clearing member default.”

Whatever the approach, the cost of funding such a scheme will be a critical issue. The cost will depend on many issues, including the structure of the fund, the cost of administration, and the amount of coverage. Equally important is the source of funding; the options include transaction fees, member firm assessments, and private insurance.

Terry Duffy, executive chairman and president of CME Group, warned that the SIPC model, which depends on funding from securities dealers, would not work as well in the futures market. “We do not have a payment-for-order-flow model in the futures industry. We have a central limit, open, transparent book for all to see. And I think that’s a completely big, huge difference when you talk about who’s going to fund these type of insurance programs,” Duffy said.

FIA’s Lukken suggested that the next step should be an in-depth analysis of the practical aspects of establishing an insurance fund. “There are serious costs that may go with these insurance programs that we have to consider. Coverage, actuarial soundness and also potentially, a lot of these insurance programs have a government guarantee behind them,” he told the Senate committee. “At a time when people are nervous about too-big-to-fail, putting in place government guarantees is something we have to seriously consider.”

Alternatives to Segregation

Instead of establishing an insurance fund, CME has raised the possibility of having customer funds held at the clearinghouse rather than the FCM. Recognizing that this would remove a key source of revenues for FCMs, CME has emphasized that it will protect the FCM business model by collecting the interest on the customer funds and passing that to the FCMs. CME has not yet disclosed how this model will work, however.

Another option under discussion is “full segregation,” meaning that each customer’s positions and collateral would be held in a separate account, rather than pooled with other customers. The CFTC considered this idea when it designed the account structure for cleared swaps, and rejected it in favor of the “legally separated operationally commingled” model. Nevertheless, the NGFA has proposed allowing full segregation as a voluntary option, available to any customer

willing to pay the necessary costs, and has suggested launching a “pilot program” to test the idea.


Another proposal under discussion is tri-party custody. In this model, customer funds would be held by a custodial bank rather than the FCM, and the FCM would have access to these funds only for the purpose of meeting margin obligations. Proponents of this model say that it would provide greater protection from fraud or misuse by the FCM, but customers are less sure. At the CFTC staff roundtable on Aug. 9, several customer representatives pointed out that in the event of a shortfall in the customer funds, customers who opted for tri-party custody would still be subject to a pro-rata distribution of any losses. The only way to fully protect against loss would be to make the use of tri-party custody accounts mandatory across all customers, they said.

Stay Focused on the Basics

At an Aug. 9 roundtable discussion held by CFTC staff, customer representatives urged the industry to stay focused on the basics—ensuring that customer money is exactly where it is supposed to be. That requires not only new rules and regulations but also a higher standard for checking to make sure that those rules and regulations are actually followed.

“While it’s very important to focus on the process and that the rules being imposed by the regulatory bodies (as well as the self-denominated rules by each entity) are being followed, I think given what we’ve seen as well as the expectation by end-users, is that the standard of care has to be considerably higher in terms of ensuring that the money is where it’s supposed to be,” said William De Leon, global head of portfolio risk management at PIMCO.

While there are many questions that still remain about potential new safeguards, industry representatives and regulators have vowed to continue working to help restore confidence.

“There is no easy solution—no magic bullet—that will bring back the trust lost in these past weeks. Instead, it’s going to take a lot of hard work across the whole industry to implement a host of improvements as to how FCMs conduct their business and how their conduct is examined and audited by the regulators,” said Lukken. 

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