Is There A SIPC In The Futures?

By Donald L. Horwitz
MarketsReformWiki Contributing Editor
Managing Director, Oyster Consulting, LLC
Email: Donald.horwitz@oysterllc.com

Not to be too blunt, but the collapse of MF Global is a disaster for the futures industry. This is the same industry that has been able to stand before Congress every time there has been a market crash (1987, 1994, 2008, to mention a few) and say proudly that the customer segregation system works well. Now, however, that is not necessarily the case. And, more importantly, this turn of events is happening just as the regulatory agencies, Congress and the industry are trying to implement the final set of rule changes mandated by the Dodd-Frank Act of 2010.

Why is this collapse such a problem, you may ask? After all this was not the kind of systemic event that the country and the financial system faced in 2008 when Lehman, Bear Stearns, and AIG failed, and Merrill Lynch was rescued by Bank of America. While a nice sized and respectable firm, MF Global was not a Morgan Stanley or Goldman Sachs.

The real issue facing the industry is not what happened to the customer funds that were required to be set aside in a segregated account at a bank, (although clearly that detail is critical to the innocent clients affected by the shortfall) but how did it happen?

The segregation provisions of the Commodity Exchange Act and the regulations promulgated thereunder by the CFTC, govern the holding, investing and use of these funds so that if a futures commission merchant (FCM) does run into a solvency issue, at least the customer funds are safe. Moreover, the CFTC and the self-regulator for the firm (in this case the CME Group) are required to periodically audit firms for compliance with these rules. If the segregation computation is incorrect, alarm bells go off and the firm must immediately come back into compliance. The firm could also be tagged with fines and penalties.

It's because this regime has worked well since it was adopted in the 1930s, that the industry has avoided the imposition of a government-authorized insurance fund similar to that of the Securities Investors Protection Corporation (SIPC). The industry's claim had merit that this additional protection on top of segregation was unnecessary. Recently, CFTC chairman Gary Gensler said segregation is the "heart of our regulatory regime." Nevertheless, he also said in remarks prepared for a speech at the University of Chicago on Nov. 16, 2011, that "it is "critical that the CFTC finish a rule that will enhance customer protections regarding where clearinghouses and futures commission merchants can invest customer funds."

Now, however, there may be a gaping hole in the system that apparently has been overlooked for years. What happens if the FCM does not properly segregate customer funds or uses the funds improperly or for its own account? This is not an issue for the clearinghouse as its obligations are to protect the other members of the clearing fund if one member defaults on its payments as a result of a customer failure. Clearing funds are not available to cover the improper use of customer funds by the firm or for that matter any other type of fraud or malfeasance on the part of the clearing firm. The only asset that may be available to customers in such a situation is a Directors and Officers Liability Insurance policy and even then it is probably not enough to cover this loss.

Catalyst for change

So, why not rethink the possibility of a SIPC-type insurance and claims process for FCMs? We understand that this concept has been resisted for years for very sound and just reasons including the fact that the segregation system works well. For the most part, there has been no pressing need to fix it.

The MF Global liquidation may be the catalyst. We now find that we have an on-the-run hybrid "SIPC" system imposed upon the futures industry without any rules and no customer protection fund. After more than two weeks into the crisis, the trustee crafted partial relief where some customers funds will be released. The trustee was able to do this only because the CME Group essentially offered to back up over-payments. Perhaps this process could be codified in the event of future situations.

Back in 1986, this writer was appointed a SIPC trustee for the liquidation of a broker/dealer in New York. During that proceeding, we learned the details of the operation, how customer claims were processed and how efficient the SIPC backed system worked. Customers either received their securities or replacements, or cash, as the case warranted. We also investigated the matter and determined that the cause of the firm's failure was that the owner of the broker/dealer used customer segregated funds to help fund another venture. Because this was deemed fraud, we filed a claim against the insurance carrier, and when it was denied, we sued the insurance company and ultimately prevailed.

In this and other SIPC liquidation cases, the customers received their securities or cash as promised. There were no questions whether this would happen; it was only a matter of time. Because this process works, broker-dealer customers are assured that their funds are protected. SIPC is not the Federal Deposit Insurance Corporation that guarantees bank deposits nor does SIPC protect the customer from losses because of a stock's poor performance. What SIPC provides is assurance that investors will get their property back if the firm blows up. As it says on the organization's website:

"SIPC does not cover individuals who are sold worthless stocks and other securities. SIPC helps individuals whose money, stocks and other securities are stolen by a broker or put at risk when a brokerage fails for other reasons."

That type of comfort might be necessary to protect the integrity of the futures markets and restore customer faith in the system.