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Protecting Futures Customers from Brokerage Firm Failures, Part 3

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Earlier articles (*farmdoc daily* [January 15, 2014](#) and [January 24, 2014](#)) described two studies which explored the feasibility of a protection fund for futures customers. The purpose of such a fund would be to quickly restore missing customer funds in the event of brokerage firm failure (such as MF Global) or fraud (such as Peregrine Financial Group).

The Commodity Futures Trading Commission (CFTC) implemented rules last month that it claims will provide greater assurance that customer segregated funds are protected. These rules do not involve any type of reimbursement fund, and instead are designed to prevent the types of problems that may lead to customer losses. Preventive steps involve such things as more fully informing customers of the possible risks of futures trading, requiring brokerage firms to more closely monitor and manage risks, boosting the capital and liquidity requirements for brokerage firms, and strengthening audit and examination requirements. One of the more controversial requirements involves how margin calls are funded. To fully appreciate the impact of these margin-related changes, we first need to review how the margining and segregated funds process currently operates.

Margins, Margin Calls, and Residual Interest

When a futures position is established, the customer must post an *initial margin*, or good-faith deposit, against potential losses. Margin levels are set by the exchanges based on market volatility and other factors, and typically are designed to cover 99% of expected one-day losses on a futures position. Each day, gains are credited to and losses are debited from the customer's margin account. If the market moves against the customer and causes his or her margin balance to fall below the *maintenance margin* level, the customer receives a margin call and must deposit additional funds to bring the balance back up to the initial margin level.

Just as a customer must maintain margin levels with his or her brokerage firm, the brokerage firm must maintain margin levels with the exchange's clearinghouse. When a customer receives a margin call, the customer is expected to provide the funds immediately. In practice, "immediately" usually has been

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interpreted as sometime the next business day, since margin calls normally are issued at the end of the trading day. Some firms allow as many as 3 business days to elapse so that customers in rural areas can mail in a check. During this waiting period the brokerage firm must use its own funds to cover the customer's margin shortfall. If the firm waits more than 3 business days for a customer's money, it must take a capital charge until the funds are received.

Brokerage firms have a broad spectrum of customers holding a wide variety of positions. For every customer that has a loss in a particular market on a particular day, the firm likely has a customer with a roughly equivalent gain in that same market on that same day. Having a "balanced book" of customers with similar levels of total long and total short positions in each futures contract means that gains will more or less offset losses in the firm's customer margin accounts. This effectively limits the amount of its own funds that a brokerage firm will need to advance during these waiting periods.

Customer funds are pooled in a single account, and brokerage firms generally keep some of their own funds in the customer segregated funds account. These brokerage firm-owned funds are called "residual interest" and provide an extra cushion against unexpected events - such as trading losses by a large customer - that could leave the customer account temporarily underfunded.

New Rules

The Commodity Exchange Act and CFTC regulations have always prohibited brokerage firms from using one customer's funds to cover another customer's losses. Until now the meaning of this rule never extended to cover the offsetting process described above. But beginning November 14, brokerage firms will be required to use their own funds, in the form of residual interest, to cover all shortfalls in under-margined customer accounts.

Under these new rules, a brokerage firm must have residual interest at least equal to the total amount of all customer margin account shortfalls; notice that this method ignores all customer account surpluses. Initially, the firm's residual interest funds must be in place by 6:00 PM Eastern Time, one business day after the shortfalls occur. By January 2019 the funds must be in place *before* the close of trading *on the day the shortfalls occur*. To have these funds in place before trading ends, the firm will need to perform real-time monitoring of customer margin account balances relative to market prices and customer positions. However, no system currently exists that would allow such real-time calculations, or to accurately predict end-of-day margin requirements.

Possible Implications

Public comments on an earlier CFTC proposal of these rules noted that customers likely would be forced to maintain account balances well in excess of normal margin requirements. Others feared that in the event of a margin call, brokerage firms would be more likely, and would move more quickly, to liquidate customer positions to avoid taking a capital charge.

Still others expressed concerns that brokerage firms would be less likely to serve agricultural customers because ag users often depend on financing from banks to fund margin calls, and getting a bank to issue a check or wire funds can require some additional time. Neither the MF Global nor Peregrine Financial Group failures had any connection to customer margin calls or brokerage firm residual interest, and several commenters questioned why the CFTC was taking these steps.

Double Default and Fellow-Customer Risk

A "double default" occurs when a customer defaults and takes down his or her brokerage firm. This puts all the firm's other customers in jeopardy, known as "fellow-customer risk." Under these conditions, the clearinghouse can use funds *belonging to the firm's other, non-defaulting customers* to cover the loss. CFTC Interpretive Letter 85-3 (available [here](#)) explains that a clearinghouse's responsibility is to the clearing firm, not to firm's customers. Therefore, when responding to a default a clearinghouse does not need to "...treat such funds as the property of the particular customers who deposited them or to whose positions they have accrued." This means that a clearinghouse may use all of the customer funds to cover losses before tapping its own capital and guaranty funds.

It is impossible to predict what actually would happen in such a situation, and the answer likely depends on the particular circumstances. But any use of one customer's funds to cover another customer's losses would be both disruptive and unpopular. The CFTC's new rules tighten margin call rules and impose residual interest requirements on brokerage firms in an effort to reduce fellow-customer risk and the need to resort to such drastic actions.

Whether these new regulations actually reduce the risk of default, and to what extent they result in higher trading costs for futures customers, remains to be seen. The CFTC will monitor this situation and publish a report by May 2016 with its findings. At that point the new rules and/or implementation schedule may be modified, or proceed to completion in January 2019.

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