

## The MF Global scandal: what went wrong in the belly of the beast?

Despite claims to the contrary, financial markets and their regulation are *not* as complex as they are often made to be. The U.S. regulatory framework supports the best and largest markets in the world, and these markets have functioned relatively well in the past (say, between 1934 and 2007). But why are we now observing the current scandals of “money gone missing”? The answer lies with two things: first, the fact that our payment and settlement is gigantic, so there are some features of the system that must be quickly modernized. The other is our tendency to under-regulate, self-regulate, and conduct business-as-usual.

The “belly of the beast” – the futures clearing and settlement system of the Chicago Mercantile Exchange (CME) – is designed to make sure that financial transactions actually take place and that money flows from buyers to sellers via proper settlement. Since futures are financial contracts (derivatives) – not stocks or bonds – the proper keeping of accounts is fundamental to the functioning of markets.

Are our systems up to date in this regard? The answer is no, and one reason is that the regulators and the central clearinghouse where accounts are kept do not monitor the clients’ accounts in real time. Real-time monitoring of accounts with the CME is made at the broker level, *not at the client level*. This means that brokers are monitored to make sure that their accounts and the *aggregate* of their customer accounts is properly collateralized (or funded) to resist wild swings in the commodities markets. Book-keeping of individual futures trading accounts is left for the brokers to do. The system works well, in the sense that the CME is protected in case a broker defaults or cannot meet a margin call. Therefore, the *system* is protected but not the individual traders.

The current CME system does not adequately protect the integrity of the accounts managed by brokers (often referred as SCMs, or self-clearing members). In a more modern system, the CME would make sure that all the individual accounts are properly collateralized at all times, simply by making a risk calculation for each account in real time and demanding additional margin if necessary. The account-by-account monitoring is called, in other parts of the world, the Ultimate Beneficiary system (UB). Under UB, the central clearinghouse (CME, in this case) would have to compute the margin for each account – i.e. for each farmer, grain trader, futures trader, bank, and so forth – in real time, thus knowing at all times if the accounts are kept properly.

Why is this not done? Presumably, the UB system would be more expensive to run. However, we live in the technology age: if American Express can keep track of credit card expenses in each account and “flag” retail transactions that are unusual and if Facebook and Google know where (and perhaps even with whom) I am having dinner tonight, then the CME should be able to assess whether customers’ accounts are well-capitalized.

The time for the Ultimate Beneficiary system has come. The risk of not having such system is that brokers mix (“comingle”, in the vernacular) their funds with those of their clients and use the money for

other purposes, like investing in Italian or Greek debt. This actually happened. Here lies the second reason behind the MF Global collapse: the permission due to lax regulation -- lobbied arduously by MF Global officers -- for the broker to engage in proprietary trading in unsupervised, non-centrally cleared bonds via private transactions with other Wall Street firms.

There is no particular reason for not moving to the UB system. As a matter of example, BM&F Bovespa, the Brazilian exchange, has put in place an Ultimate Beneficiary system. BM&F Bovespa is very large and clears stocks, futures and other derivatives. To ensure that integrity of all trading accounts and payments in the financial system, UB is firmly in place.

Recent newspaper columns by Darrell Duffie<sup>1</sup> and CME market officials fail to consider squarely the UB solution. Instead, they suggest that more reporting requirements could solve the problem. Others, like me, believe that if we want efficient futures markets we need to build the proper infrastructure to support them.

Incidentally, UB is also better for monitoring market manipulation. Since all trades are identified by the person or firm who does the trade and not just by the broker, a trader who engages in market manipulation (for instance via high-frequency trading) would be identified immediately. How is that for leveling the playing field?

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<sup>1</sup> After MF Global: how to protect customers' cash, Financial Times, January 2012