

November 10, 2011 – An Unmitigated Disaster

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Oftentimes, the significance of truly historic events is not fully appreciated at the time they occur. I think we are at one of those times with the bankruptcy of MF Global. There's no question that the news and overall circumstances of the demise of the large commodities brokerage is widely known, but the significance of the event is not yet fully understood. While I would classify the event as an unmitigated disaster on many levels, I have hope that it might result in some long-overdue and necessary changes in the commodities regulatory structure.

The disaster is that for the first time in modern financial history, the main guarantee of the clearinghouse system has completely failed its most important constituent – the customer base. The underlying promise to every participant in the futures market is that your money and open positions are safe from theft and default. This is the very glue that holds the future market together, namely, that all market participants can depend upon strict regulation and oversight to safeguard against fraud and theft. That's what has made the US organized futures exchange system the envy of the world. Until now. For more than a week, almost all of the 50,000 commodity customers of MF Global are in limbo as to the access and status of their funds on deposit and open positions. This is unprecedented and beyond bad. For these 50,000 customers, it's the equivalent of discovering your bank just went out of business and there is no assurance all your funds will be returned. (In the interest of full disclosure, my background is in futures, having started as a commodity broker at Merrill Lynch some 40 years ago. But I have not traded futures for years and am no way personally involved in the MF Global mess; I'm strictly an outside observer and independent analyst).

Let me cut to the chase here and pinpoint the real problem – the CME Group. I know I have continuously criticized the CME, even calling it a criminal enterprise on many occasions, but in truth I may have understated the case. Yes, I would agree that the immediate cause of the MF Global bankruptcy was MF Global itself; but what turned it into a disaster of unprecedented proportions was the CME Group. The CME Group was the front line regulator for MFG, responsible for auditing and insuring the safety of customer funds and for guaranteeing those funds in a worst case scenario. The CME failed at every turn. Not only did its auditing fail miserably, the CME failed to step up to the plate to safeguard customer funds after it was discovered that \$600 million was missing. This is like a case of paying premiums for years on an insurance policy only to be denied coverage when presenting a claim for the first time. I know that the federal commodity regulator, the CFTC, has been negligent in the case of MF Global as well, but that does not mitigate the CME's failures.

Of the twin failures by the CME in the MF Global bankruptcy, clearly of more significance is its failure to stand up and guarantee that all MFG customers would be immediately made whole by the clearinghouse system run by the CME. The clearinghouse system, a consortium of financial firms whose collective finances stand behind every trade, has been the main backstop to all futures trading for many decades. It was widely understood by all market participants that if a clearing member failed, all the other clearing members and the exchange itself would step in to guarantee customer funds and prevent contract default. The CME boasts on its web site that anywhere from \$8 billion to \$100 billion in protection is available in the event of a clearing member failure. If it was telling the truth, it would seem \$600 million should be no problem. <http://www.cmegroup.com/clearing/cme-clearing-overview/safeguards.html>

Instead, we all have a very big problem, thanks to the CME Group. Our financial and credit systems are based upon trust and belief. The word credit itself comes from the Latin word – credere – or to believe. What the CME Group has done by not immediately guaranteeing all MF Global customers and positions is to undermine belief in the futures market clearing system. So important is this issue that I am at a loss to explain how the CFTC hasn't yet mandated that the CME do the right thing. And I have been somewhat dumbfounded that the analytical community and media haven't been all over this, but there was an article in today's NY Times that discusses the CME's failures for the first time. <http://dealbook.nytimes.com/2011/11/09/clients-question-oversight-by-mf-globals-regulator/?partner=yahoofinance> In addition, there was a well-written article on the Internet that did describe the problem and the CME's role. http://seekingalpha.com/article/306068-cme-is-legally-liable-for-mf-global-customer-losses#comments_header Please pay particular attention to the comments submitted on both articles.

Worst of all, even MF Global customers who held no open futures positions and only cash and unencumbered assets, like registered warehouse receipts for silver, gold and other commodities, have found those assets under the control of the bankruptcy trustee. If you do own warehouse receipts on silver or other commodities that are tied up in the MF Global bankruptcy, you must run, not walk, to a securities attorney to secure your legal rights to your property. This is not a matter of what is right or wrong, as the unauthorized appropriation of private property is never correct. This is a matter of law, which sometimes is not the same as what seems right or wrong. Please don't delay. The CME is to blame for all of this, but blame must be saved for later.

If there is any good that might come from this whole sordid affair it is that it may shine the light on what needs to be done. What needs to be done is that the CME Group must be stripped of any regulatory powers it has. As I have long contended, there is a clear conflict of interest in having a for-profit entity set its own rules and regulations, especially an entity that shows nothing but contempt for its own members at large and its customers. The CME Group spends all of its energies encouraging artificial trading schemes, like High Frequency Trading, designed to increase trading fee revenue and not on market integrity and customer protection. The CME Group has just demonstrated to the world its contempt with its failure to stand behind MF Global customers even though it promised to do so beforehand. Next time you watch the CME Group commercial that runs incessantly on financial TV that proclaims how farmers and airlines come to the exchange to hedge their price risks, please keep in mind that the CME just abandoned those farmers and airline customers who were MF Global clients.

One other small bonus that has emerged from this disaster is that the event has revealed as a lie all the nonsense that CME leaders have publicly proclaimed about the integrity of their markets. For the past few years, the smug and arrogant leaders of the CME have testified publicly before congress and the media about how the exchange's clearinghouse system withstood and avoided the failures of the non-clearinghouse financial system as typified by AIG. CME officials trumpeted the advantages of it being a Self-Regulatory Organization (SRO), quite capable of handling regulatory matters without the need for further government regulation. Unfortunately, even high officials of the CFTC were apparently sucked in by the appearance of financial strength and integrity portrayed by the CME's clearinghouse system of guarantees and the wisdom of letting it continue to regulate itself. That has now all been shown to be a lie. What good are guarantees if they are not honored when need be? What good is self-regulation if it leads to the wholesale abandonment of the customers' financial interest?

Fortunately, there is a simple remedy to the calamity of distrust growing in our market system as a result of the CME's failures. The CFTC must immediately force or persuade the CME Group to do what it has promised and should have done on its own, namely, immediately guarantee that all customers of MF Global are made whole. Let the lawyers battle it out as to who is ultimately liable after all the customers have been made whole. That the CFTC hasn't done this yet is bizarre. If the Commission delays longer what is now clearly a primary failure at the CME will soon become primarily a CFTC problem. We need adult supervision right now. Clearly the CME Group is not up to the task. If the CFTC doesn't take over responsibility and force the CME to do the right thing, God help us all.

Another thought in closing. The CFTC's recent official affirmation that it is continuing its three year old silver investigation shines another spotlight on the CME.

<http://www.cftc.gov/PressRoom/PressReleases/silvermarketstatement> The investigation of silver by the CFTC clearly involves the CME, as the world's leading marketplace for silver is the COMEX, owned by the CME for the past three years. Yet the CME has never said one word about the ongoing silver investigation as it has been content to hide behind the CFTC and pretend there are no allegations of a silver manipulation. I guess that is to be expected from an entity that regulates itself.

I'm purposely confining my comments to the emergency at hand. There is no change in the silver outlook. It is still a crooked market destined to go much higher in the long run. The sooner the CFTC cracks down on the CME and then addresses the silver manipulation, the sooner those higher prices will come.

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Silver – \$34.00

Gold – \$1756

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