Asset Safety in the post-MF Global World

December 26, 2011

We wish our clients, referring consultants, professional colleagues, friends, and all of our readers a happy holiday season and a healthy new year. We also encourage them to ask very hard questions as they work to keep their money and investments safe.

We start this yearend message with a reminder of who we are. We are a separate account manager. That is why we do independent research. We look at what rating agencies say, but we make our own evaluations about credit issues. We do not take custody of clients' funds. We favor a three-silo approach to money management: we believe that custody, advice, and transactions should all be separately accounted for and independent of each other. That advice would have avoided Madoff, Nadel, and MF Global. It also requires the investor to dig deep into the account arrangement that he/she uses.

We look at the world as an organization of interdependencies. Some are negative and some are positive. They are intertwined. They come in all sizes and shapes. We are using these metaphors to describe the global construction of finance, economics and government. In today's world there is no complete isolation, not in Russia (Putin protests), not in Syria (City of Homs), not even in despotic North Korea. In today's world, one may deceive, steal or oppress but one cannot permanently hide.

We start with a perspective articulated by Tommaso Padoa-Schioppa five months before his death. See the Per Jacobsson Lecture, Basel, June 27, 2010 (hat tip Steve Ganns). Google will take you to the full text and to the Padoa-Schioppa bio.

With brilliantly constructed prose, Padoa-Schioppa said:

"Humans sharing common interests constitute groups of different sizes on a scale that goes from the condominium to the population of the world. Goods like a garden, the judiciary system, navigation on the Rhine, or the biosphere, are 'public' for jurisdictions such as a town, a country, a continent, or the planet.

"It follows that also government – as provider of public goods – needs to be constructed at different jurisdictions and to refer to different constituencies. Government must be plural and multi-level. The Jacobin aspiration to concentrate public power in the hands of a single ruler produces both oppression and ineffectiveness.

"The present crisis stems largely from the inconsistency between the increasingly cross-national span of markets – be it regional or global – and the persistently national span of government: lack of an international monetary order providing a degree of macroeconomic discipline, regulatory competition among financial centers to attract bits of global financial industry, etc. This defective aspect of the relationship between markets and government – one of the most important flaws in the market-government nexus leading to the crisis – cannot be simplistically described as a 'lack' or an 'excess' of government. The defect lies in the level rather than in the quantum of government and has deep roots in the field of practices and in that of ideas."

Wow! If ever we saw a summary of interdependence issues applicable to the global financial arena, this is it. Moreover, it only took him three paragraphs. We will leave you to ponder this, dear reader, and will move on with this as a context.

Here is some specific food for thought as we enter the New Year. We offer these citations and examples to the many readers who inquired about our writings on MF Global, on rating agencies, on the Fed's primary dealers and on the state of the financial world. Those commentaries are archived at www.cumber.com.

On August 3, 2011 (notice the date) Moody's wrote the following as part of a credit report on MF Global. "In summary, there are clear positive indicators of management's ability to execute." Moody's then reaffirmed the Baa2 rating and said, "MF Global recently obtained the Primary Dealer status with the Federal Reserve Bank of New York. Achieving this milestone is a credit positive because it should 1) broaden MF Global's secured funding base, 2) add positive momentum to its brand and franchise building efforts, and 3) expand the size and capital efficiency of its US treasuries trading operation." Moody's had earlier affirmed the Baa2 rating, on February 3.

Remember that the Fed maintains that primary dealer status confers no special financial creditworthiness and that the primary dealer designation should not infer it. The Fed specifically disclaims special status. Obviously, a rating agency thinks differently. Perhaps the Fed will take note during the New Year, as it considers the damage that has been done since the Greenspan-Corrigan decision (1992) to remove Fed surveillance of primary dealers.

On December 13, 2010, Standard and Poor's rated MF Global BBB- with a "stable outlook." S&P said, "The company has been in a prolonged turn-around mode for the past two years, but we consider the most recent strategic plan of the new CEO Jon Corzine to be sound. This plan focuses on developing the firm's historic broker model into more of a broker-dealer model, which should eventually increase and diversify revenue and lead to better profitability."

So, 2011 witnessed the MF Global saga. The firm became a primary dealer with the Federal Reserve, had its investment-grade rating reaffirmed, and then blew up. What does that say about positive and negative interdependencies and "level" vs. "quantum" of government? Tommaso, we offer you posthumous praise and wonder if your spiritual ears must be ringing.

We have written extensively about the hypothecation issue and will introduce some further evidence below. Let's close the rating agency discussion with the following sarcastic quote.

"The function of a ratings agency is to visit the field at the end of the battle and shoot the wounded." – John Heimann (former US Comptroller of the Currency), spring, 1998; source, Brookings (hat tip, Barry Ritholtz). Readers may note that the Global Interdependence Center is hosting a conference on rating agencies, February 29 in Philadelphia. See www.interdependence.org for details.

Now, on to explaining why we are so harsh on the City of London and why we see hypothecation as such a huge risk. We believe that no new safety became available in the City between the Lehman debacle and the MF global affair. Here is an example of a government (the UK) saying something is unsustainable and then doing nothing about it. Tommaso's level and quantum are both violated. The interdependencies are clearly negative. Proof follows.

Reuters reported that, "Under the U.S. Federal Reserve Board's Regulation T and SEC Rule 15c3-3, a prime broker may re-hypothecate assets to the value of 140% of the client's liability to the prime broker. For example, assume a customer has deposited $500 in securities and has a debt deficit of $200, resulting in net equity of $300. The broker-dealer can re-hypothecate up to $280 (140 per cent. x $200) of these assets. But in the UK, there is absolutely no statutory limit on the amount that can be re-hypothecated. In fact, brokers are free to re-hypothecate all and even more than the assets deposited by clients. Instead, it is up to clients to negotiate a limit or prohibition on re-hypothecation. On the above example a UK broker could, and frequently would, re-hypothecate 100% of the pledged securities ($500)."

More from Reuters: "Under subtle brokerage contractual provisions, U.S. investors can find that their assets vanish from the U.S. and appear instead in the UK, despite contact with an ostensibly American organization. Potentially as simple as having MF Global UK Limited, an English subsidiary, enter into a prime brokerage agreement with a customer, a U.S. based prime broker can immediately take advantage of the UK's unrestricted re-hypothecation rules. In fact this is exactly what Lehman Brothers did through Lehman Brothers International."

Here is the actual text of a paragraph from an MF Global account document executed with a client.

"7. Consent To Loan Or Pledge

You hereby grant us the right, in accordance with Applicable Law, to borrow, pledge, repledge, transfer, hypothecate, rehypothecate, loan, or invest any of the Collateral, including, without limitation, utilizing the Collateral to purchase or sell securities pursuant to repurchase agreements [repos] or reverse repurchase agreements with any party, in each case without notice to you, and we shall have no obligation to retain a like amount of similar Collateral in our possession and control."

Source: Thomson Reuters, "MF Global and the great Wall St re-hypothecation scandal"

Reuters' research noted that "Once in the system collateral is being pledged and re-pledged over and over again either through sale and repurchase agreements or re-hypothecation as demonstrated by a review of SEC filings. For instance, Goldman Sachs disclosed recently that it had re-pledged $18.03 billion of collateral received as at September 2011, Oppenheimer Holdings re-pledged approximately $255.4 million of its own customers' securities in the same period, Canadian Imperial Bank of Commerce re-pledged $72 billion in client assets, Credit Suisse sold or re-pledged CHF $332 billion of assets (received under resale agreements, securities lending and margined broker loans), Royal Bank of Canada re-pledged $53.8 billion of $126.7 billion available for re-pledging, Knight Capital Group delivered or re-pledged $1.17 billion of financial instruments received, Interactive Brokers re-pledged or re-sold $7.9

billion of $16.7 billion available to re-sell or re-pledge, Wells Fargo re-pledged $19.6 billion as at September 2011 of collateral received under resale agreements and securities borrowings, JP Morgan sold or re-pledged $410 billion of collateral received under customer margin loans, derivative transactions, securities borrowed and reverse repurchase agreements and Morgan Stanley re-pledged $410 billion of securities received."

Here is a paragraph of text from the detailed margin-account disclosure agreement of Morgan Stanley Smith Barney:

"We may borrow money to lend to you or other margin clients and pledge your securities as collateral for such loans. You authorize us to lend any security in the margin credit portion of your Account, together with all attendant rights of ownership, either separately or together with the assets of other margin clients, to us or to others without notice to you. In connection with such loans, and securities loans made to you to facilitate short sales, we are authorized to receive and retain certain benefits, including interest on your collateral posted for such loans, to which you may not be entitled. In addition, we may receive compensation in connection with such loans. In some circumstances, such loans may limit your ability to exercise voting rights of the securities lent, either in whole or in part."

Source: http://www.morganstanleyindividual.com/customerservice/disclosures. Note: this is not unique to MSSB. Nearly all firms have similar language.

The client enters into this agreement by doing nothing. To avoid it the client has to opt out. Here is the line of text used in the account document. "Please note that you are automatically requesting margin privileges unless you check the 'NO MARGIN' Box."

This safety-threatening risk is manageable if the client is alert and informed. Limit brokerage to a cash account. Set up custody in a way that does not give the custodian permission to use the assets. Deny the ability to lend or hypothecate. But the client or the investment adviser needs to be alert.

Also, note that there is usually a cost attached to the secure safekeeping of assets. Firms try to induce you to allow hypothecation because they make money off of your assets when they use them. It is worth paying for independent safety, in our opinion. At Cumberland, we use several custodians, including major brokerage firms and banks. We strive to set up these accounts around the principle of three silos. We recognize that there are times when clients need to use margin in order to borrow. That is okay as long as it is monitored. And when you pay back the loan, you can revoke the margin agreement if you do not plan to borrow again. In other words, pay attention to these details and take nothing for granted.

Let's wish for better regulation and more transparency and honest execution in the new year. Maybe it will even happen in the UK. The world is a dangerous place these days. Vigilance is called for. Interdependencies are both positive and negative.

On that note, we reaffirm our best wishes for the New Year. We do not plan to drink and drive. We equate drunken driving to asset placement where there is open-ended hypothecation risk. You may survive but the danger is high. Stay safe and have a happy New Year.

David R. Kotok, Chairman and Chief Investment Officer

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