Refco – a gentle reminder for customers

Refco, one of the world's biggest futures brokers with operations in 14 countries will have disappeared by the time you read this piece.

It was controlled (and largely owned) by Philip Bennett, CE and chairman, whose role was largely hidden from view. The public face was Joseph Murphy, head of Refco Global Futures, a respected statesman in the industry and chairman of the Futures Industry Association. Despite the odd infelicity in its past, Refco was a respectable and respected organisation.

However all was not as it seemed – various stories have been reported, and there are perhaps more to come. It is alleged that some four years ago Bennett used $430m of Refco's money to create private entities, to mask non-performing debts dating back to the Russian and Asian financial crisis in 1998. What happened next is unclear, however, it seems that the Bennett-controlled entities and Refco would flick the debt between them, so that it appeared as a performing debt hiding the underlying reality. Refco auditors, Grant Thornton, was quoted in the *Daily Telegraph* stating, "it is clear that a receivable from a related party was specifically hidden from us as Refco's auditor by transfers to third party customer accounts".

Bennett, now facing securities fraud charges, denies any wrong doing. He has repaid the debt, apparently with the aid of a $242m loan from Bawag (a Swiss based bank apparently connected with the Australian trade unions). Much to their disappointment the loan was secured on his, now worthless, Refco share holding.

The irregularities were first reported in the UK on 11 October. Shortly after these initial reports, Refco Capital Markets, one of the main operating units, ran out of liquidity imposing a 15-day moratoria on customer exits. Refco filed for Chapter 11 protection from its creditors in late October and, at the time of writing, the liquidator is now auctioning the Refco subsidiaries.

So in little more than a month, Refco has gone from industry leader to extinction.

There has been much speculation as to Bennett's motives. Much has centred on Refco's $583m IPO in which Bennett sold 5.3m shares (nearly 5% of Refco) earning him $116.6m. He still retains 43m shares, or 34% of Refco.

Whether it was greed or something else, will doubtless be the subject of further press speculation.

The debate continues as to whether the hidden debt should have been detected. This has lead to the usual game of trying to assign responsibility after the event. Those involved in the IPO have been quick to point out that they relied on the accounts and that appropriate risk warnings were given. Grant Thornton claims it had previously reported "significant deficiencies" in Refco internal controls and financial reporting.

So what's different this time?

What strikes me about the Refco story is that old adage "so what's different this time?". The answer is – nothing. We have a situation in which an individual in a position of trust and influence has misused that position for whatever reason. Even the timing is about right, these events turn up every six or so years. The demise of Sussex Futures, in a lunch time, and the overnight demise of Griffin Trading in fairly quick succession were around six years ago – both brought down by individuals in a position of trust and influence.

All of this leads me to reflect on the position of customers – whether it be customers of prime brokers, traders trading for their own account or industry users.

Due to the principal-to-principal nature of our industry, customers need to take great care when selecting their counterparties. The same caveat emptor which applied to investors in the Refco IPO also applies to customers. Whenever an account is opened with a broker, it is essential that the customer undertakes appropriate due diligence.

Regulated or unregulated?

Refco operated through a number of subsidiaries: Refco Global Futures, Refco Securities, Refco Clearing, Refco Overseas and so on. The regulated subsidiaries have apparently been "substantially unaffected" by the events which have unfolded (according to a Refco statement) and in London, LCH Clearnet was moved to issue a statement that Refco Overseas was in good standing with it.

On the other hand, the more profitable and a significant contributor to Refco's revenues, Refco Capital Markets (an unregulated off-shore broker), was apparently not subject to any regulatory oversight. It was the Refco entity which first ran into trouble and its customers were those locked in.

The first issue a customer must consider is whether the counterparty they deal with is an exchange member or regulated. If it is an exchange member or regulated, the customer has the comfort of knowing that it has been subject to external scrutiny to have achieved this status. Unsurprisingly, some firms have a policy of only dealing with counterparties who are exchange members or regulated. Others, including a fair number of proprietary traders deal with unregulated counterparties who are themselves only customers of exchange members.

However, should a customer go further? Probably – even regulatory oversight has limitations.

Vincent Mercer* examines the Refco scandal and how customers should be aware of caveat emptor to ensure they don't get caught out in the future

Someone undertaking due diligence might have been concerned that (contrary to conventions in the UK) Bennett held both the role of chairman and CE. However, the fact that a reputable firm of auditors audited Refco's accounts, might have given rise to comfort – how many customers would have asked for or studied the accounts? If as Grant Thornton say, anyone had looked at their reports their unhappiness with Refco's financial controls might have come to light. Furthermore, how many customers would look at a potential counterparty's disciplinary record or visit the back office for example?

In reality most customers undertake little or no due diligence on counterparties. Perhaps it is time this changed.

Seg or non-seg?

Having opened an account a customer needs to consider if they want to be treated as segregated or non-segregated.

A non-segregated customer (eg a customer dealing with a prime broker) will have their money and positions treated as the broker's money and positions. This has the advantages of credit line, margin line, generally some form of gearing, however it might be characterised. While the customer gets the benefit of gearing, they lose the separate identity of their money. Essentially, what they trade is gearing for a debt. If the broker defaults, the customer's only entitlement is to claim the return of their money as an unsecured creditor. As an unsecured creditor the customer ranks behind all of the priority creditors, the taxing authority, the employees and any secured creditors (for example, the broker's bankers).

In the litigation following the Griffin default (in which I was involved) I argued that in line with a theory of law (established in a 1967 case involving Quisclose Investments), money given for a particular purpose could only be used for that purpose. In effect, held on trust by the recipient only to be used for the purpose for which it has been given. This argument was rejected by the Court. There is no inherent principle in English Law which will separately identify different pots of money within a defaulting firm.

Therefore, a customer opting for non-segregation may well have a limited or no right to the recovery of their money.

Customer's opting for segregation are in a better position in theory. However, all segregation does is to segregate a firm's customers' money from the firm's. In the event of a default and a shortfall in the pool, each participant will participate commensurate with their share of the pool. Griffin was a non clearing member of Eurex and used Fortis as its clearing member. When, to cover some of the losses arising on the Griffin segregated (client) account with Fortis due to the trading activities of John Ho Park, a substantial payment (some £2m ($23.5m)) was paid to Fortis from the Griffin client account. This was a proper payment but the result was that every Griffin segregated customer had to share in the resultant short fall created by that payment. So, being segregated is not a complete answer.

Designated account

A customer can only ensure that their money is completely segregated and separately identified by holding it in an account which contains only their money and ideally one which is clearly identified as belonging to them. In the event of a default under FSA's client money rules, client money held in each client money account will be treated as pooled. So, to be absolutely safe, a customer should have their money in an account which holds no other customer's money. The theory is great but in practice it might be difficult to find a broker willing to provide such a facility.

Anti-netting agreement

The Griffin litigation centred on customers trading through GLH. One GLH customer, Park, had a huge deficit on his account whereas every other trader had a positive balance. The Griffin liquidator argued that the accounts of all the traders should be netted and the customers' positive balances used to offset the deficit on the Park account. However, GLH had put an agreement in place with Griffin, whereby it had been agreed that in the event of there being a shortfall on any account Griffin would look only to the GLH house account not the account of any GLH customer. This was upheld – the Court felt that there was no inherent problem in parties agreeing between themselves that only certain accounts would be debited in the event of a default.

Lessons to learn

Do the due diligence – work out the level of risk you are prepared to take (opt for segregation if your appetite for risk is limited). Remember, the best form of protection for your money is simply to make sure that only the minimum amount of money is left with the broker at any time. Look at alternatives to cash such as putting up a guarantee in place of cash (although this has cost implications) and consider having an agreement with the broker which sets out what accounts should be subject to netting in the event of a default.

The investors in Refco invested in an expensive lesson in caveat emptor there is no reason why a customers should pay the same price when opening an account with their broker. ❑

****Vincent Mercer***
(vincent.mercer@speechlys.com) is a partner with Speechly Bircham's financial services group.

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