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Ask the Professor: Give-Ups After Griffin — What Changes are Needed Now?

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Give-Ups after *Griffin*—What Changes Are Needed Now?

by Ronald H. Filler

Introduction

The use of give-ups is a very common practice in today's global futures markets. However, over the past two months, this practice has received considerable attention and has been the subject of great debate as to whether any changes to give-up procedures are needed after the bankruptcy collapse of Griffin Trading Company ("Griffin"). Griffin, a U.S. futures commission merchant, also operated through a branch in London. According to various sources, one of its customers placed a large order on EUREX through an executing firm. This trade resulted in a loss of several million dollars, thus forcing Griffin to file for bankruptcy. As of March 1, many issues, especially those issues involving the comparability of global bankruptcy and segregation laws, still exist and are fit subjects for another article. However, because the actual trade that caused Griffin's bankruptcy involved a give-up transaction, this article will address issues surrounding give-ups and whether any changes to give-up practices are needed in today's global marketplace.

Give-ups occur when a firm, known as the Executing Broker, executes a futures order on behalf of a futures customer, and then transfers or "gives up" the fill to the customer's clearing firm, known as the Clearing Broker, to process or clear the order in the respective customer's futures account. If the customer's account is managed by a Commodity Trading Advisor or some other third party money manager (collectively referred to here as a "CTA"), then the CTA places the order with the Executing Broker who in turn allocates the order to the respective Clearing Broker. If the CTA clears its futures accounts among many clearing firms, then the Executing Broker would allocate the fills among all of the Clearing Brokers. As you can see, the execution and processing of these orders can be burdensome and requires thoughtful and timely communication among the parties to prevent and minimize potential problems associated with clearing give-up trades. This process also requires an agreement.

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Give-Up Agreements

The Futures Industry Association ("FIA"), together with the Managed Futures Association ("MFA"), established two versions of a Uniform Give-Up Agreement in 1995, both of which are now universally accepted by most brokerage firms and end users. One version, known as the Trader Version, is the principal Give-Up Agreement used today. This version, although structured as a four party agreement, permits the Trader, typically a CTA, to sign the Give-Up Agreement on behalf of, and thus bind, its underlying futures customers. In fact, paragraph 2 of the Trader Version specifically states that the Trader has represented that it "is expressly authorized by Customer to enter into" the Give-Up Agreement on behalf of its customers. However, in some rare situations, the Customer itself will sign the Give-Up Agreement.

The other version, known as the Customer Version, is a three party agreement, whereby the actual Customer signs the Give-Up Agreement. No CTA or third party is involved in the placement of the order on behalf of the actual customer; the Customer places the order directly with the Executing Broker.

Popularity of Give-Ups

Give-ups became popular several years ago when the managed futures industry recognized the need for simplicity and efficiency in the execution of orders that would eventually be cleared by several clearing firms. A CTA who managed multiple customer accounts that were cleared at 10-15 clearing firms, found it difficult and burdensome to place orders directly with each clearing firm. Instead, the CTA would use one firm to execute orders for all of its accounts and then requested this single Executing Broker to allocate the trade fills among the various Clearing Brokers. More recently, it has become a popular method as CTAs (and Customers) started to trade globally. Some clearing firms did not have a presence overseas. Also, the more sophisticated CTAs recognized the need to execute the futures order through the same firm in which it did its cash business or which had a strong floor presence, even though that firm was not its global futures clearing firm. Thus, the execution business flourished, and execution and clearing became two separate and distinct functions on the global futures markets.

Need for Prompt Communication

The biggest problem facing CTAs and Customers who execute their futures orders through non-clearing

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firms is communication. The CTA (and the Customer) has a requirement, even a duty, to communicate the allocation of such fills and to inform the respective Clearing Broker of executions made through another firm during the business day. Failure to provide this information timely can result in trades not being processed properly among the actual customer accounts or being held overnight by the Executing Broker. This can result in systemic issues as the Executing Broker must now post margin for an account that it has neither received margin funds from or has contracted with. Also, the Customer does not post margin funds with its Clearing Broker for such trades as the Clearing Broker has not "received" the fill from the Executing Broker. This was a problem in the *Griffin* matter.

Allocation of Orders

Historically, a CTA who trades for multiple accounts must promptly notify, at or prior to the execution of the order, the Executing Broker as to how the fills are to be allocated among the respective customer accounts it is managing. Last summer, the CFTC adopted the "post trade allocation" rule (Reg. 1-35(a-1)(5)), which permits a CTA to communicate such allocation after the execution of the order, but by no later than the end of the respective business day, provided the CTA has met certain tests. They are:

- The CTA must qualify as an "eligible account manager" (e.g., registered as a commodity trading advisor with the CFTC or as an investment adviser with the SEC or certain foreign advisors);
- The CTA employs an allocation system that is sufficiently objective and specific so that the allocations can be verified in an independent audit to be "fair, equitable and non-preferential";
- The CTA sends a disclosure to all of its customers prior to placing the first such order that states in essence: (i) the general nature of its allocation methodology, (ii) the fairness standard of its allocations, (iii) the ability of its clients to review summary or composite trading among its customer accounts, and (iv) whether any accounts in which the CTA might have an interest would be included in the allocation;
- The CTA provides a list of its "eligible customers" who qualify for this post trade allocation to its clearing firm (the term "eligible customer" is defined in this new CFTC rule and is in essence the same type of customer that meets the standard set forth in Part 36 for "eligible swap participants.")

In the preamble to the Federal Register release in which the "post trade allocation rule" was adopted, the CFTC stated that "the requirement that the account manager identify eligible customer accounts to the FCM should enable the FCM to insure that allocations are made only to those eligible customer accounts." This language has resulted in substantial debate as to what obligations, if any, does a clearing FCM have to insure that only "eligible customer accounts" have participated in an order involving a post trade allocation when the CTA itself has the burden to make sure that only such eligible customers are included in the post trade order.

In recent meetings with senior CFTC staff, it appears that, if a CTA only executes for customers, all of whom meet the "eligible customer account" definition, then the clearing FCM has no obligation other than, as noted above, to receive a list of those eligible customer accounts from the CTA. If, however, some of the accounts cleared through the FCM and managed by the CTA do not meet this definition, then the FCM might have some additional responsibility to review these orders. There is no exact method or procedure to be undertaken by that FCM to complete that review. Also, how often the review takes place might vary as well.

Regardless of when orders are allocated to the respective customer accounts, a bigger and more important issue is the need for the CTA (or Customer) to communicate in a timely manner to its Clearing Broker that it has placed an order for execution through another firm or person.

However, the clearing FCM, applying procedures it believes meets a best practice approach, could perform some or all of the following steps:

- Request a copy of orders or the blotter used by the CTA to determine whether any non-eligible customer accounts were included in any post trade order placed by that CTA;
- Review the trade registers provided by the exchanges which provide some type of identification regarding post trades (it appears that both the CBOT and the CME might be prepared to provide soon an identification, such as a 'P,' on any such post trade orders); and
- Check its floor order tickets or those of executing brokers if a give-up trade occurred, to make this same determination, etc.

Regardless of when orders are allocated to the respective customer accounts, a bigger and more important issue is the need for the CTA (or Customer) to communicate in a timely manner to its Clearing Broker that it has placed an order for execution through another firm or person. If the Clearing Broker is not aware that such order has been executed, then it cannot look to the Executing Broker for the fills or to the Customer for margin funds. This can only create administrative problems as well as financial risks. Thus, each CTA (or Customer) must understand its responsibility to communicate such information promptly to its Clearing Broker.

Exchange Rules — Need for Change

Some exchanges have rules that require Executing Brokers to notify the Clearing Broker within a particular time period and to have all required account information so that the Executing Broker directly inputs the trade information into the clearing house system that is eventually confirmed by the Clearing Broker. Also, the major U.S. exchanges, and LIFFE in a non-mandatory way, provide for an automated payment system of the executing fees or floor brokerage. This automated floor brokerage payment system must be adopted by all exchanges worldwide that permit give-ups to take place.

It is also important that the exchanges establish rules that govern the responsibilities of all parties—the Executing Broker, the Clearing Broker and the CTA/Customer—regarding give-up trades. By establishing exchange rules regarding this conduct, then all parties are fully aware of their respective duties and obligations. Give-Up Agreements would be unnecessary other than to establish the execution fee. Such exchange rules, however, must be uniform. A Give-Up Task Force could be established, which would include representatives from the major international exchanges, the brokerage community, CTAs and other end users, to establish a global uniform exchange give-up rule. Therefore, all issues relating to such obligations and responsibilities would be resolved in advance of any execution.

Needed Changes to the Give-Up Agreement?

What changes are needed to the Give-Up Agreements established in 1995 by the FIA and MFA after the explosive growth of give-ups in general and the *Griffin* matter in particular? The simple answer is **none**.

The Agreements have not created any problems relating to give-up trades nor did they exacerbate the *Griffin* matter. Both versions of the Give-Up Agreements provide language that permits the Clearing Broker to establish trade limits with respect to any order placed by a CTA (or a Customer). While most Clearing Brokers do not establish these limits, they are permitted to do so. The are many reasons why such limits are not provided; the most important one is that they would be difficult to establish. For example, Clearing Broker XYZ limits a Customer to 500 CBOT Treasury Bond contracts in its futures account. The Customer now wants to execute through three Executing Brokers. The Clearing Broker could not restrict all three Executing Brokers to 500 contracts each; thus, the Customer could in theory place up to 1,500 contracts (500 contracts at each of the three Executing Brokers). Similarly, the Clearing Broker could not establish limits equal to 167 contracts in each Agreement (e.g., three times 167 contracts equals approximately 500 contracts) as this may not be particularly fair as well.

What is needed is the duty and the obligation for both the CTA/Customer and the Executing Broker to notify the Clearing Broker promptly (e.g., within a certain time frame) that an order has been executed on behalf of the CTA (or Customer). This does not suggest that the allocation be necessarily given within that time frame, only that the fill be reported within that time period. Therefore, the Clearing Broker will know, within a short time, that such an order has been executed. This should give the Clearing Broker sufficient time to assess the trade and whether any further action needs to be taken (e.g., whether the CTA or Customer has exceeded its margin requirements and thus be forced to liquidate some or all of the trades at issue).

The [Uniform Give-Up] Agreements have not created any problems relating to give-up trades nor did they exacerbate the Griffin matter.

Communication is required whether it be an exchange with open outcry or an electronic trading system. Hopefully, all electronic trading systems will someday be structured in a manner whereby the Clearing Broker knows instantaneously that an order has been placed by a CTA (or Customer) which would be cleared through the Clearing Broker, but this information does not exist today—and it should. The Task Force should also establish best practices for electronic trading systems and open outcry, so that these systemic issues can have minimal effect.

Query, what could have been prevented had Griffin officials known early on that its customer had placed such a large order? The Give-Up Agreement was not the issue, although one may or may not have existed. The real issue was the lack of communication and the movement of the market during this information blackout. Information needs to be communicated so that adequate risk management procedures are established to prevent another such occurrence. You can not legislate against this practice, whether it be on the open outcry or electronic trading system markets—you can only establish proper and adequate procedures to minimize any adverse impact.

Thus, orders can and should be allowed to be given up, but so should the information surrounding them. Early communication is the best risk management tool the global futures industry can have with respect to give-ups■