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Statement of the Shadow Financial Regulatory Committee on

MF Global and the Implications for the Primary Dealer Structure

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The collapse of the primary dealer, MF Global, has exposed weaknesses in the Commodity Futures Trading Commission’s (CFTC, the firm’s primary regulator) and Federal Reserve Bank of New York's ability to evaluate the risks that the institution's operations and risk profile posed to creditors, clients and counterparties. The problems in MF Global should have been readily apparent to the CFTC and especially to the Federal Reserve Bank of New York had the latter been monitoring the firm in MF Global’s role as a primary dealer and counterparty to the Fed’s daily system open market trading activities. Timely and relevant information to assess MF Global’s condition was publicly available through its 10K SEC filing, which clearly detailed its risk profile and exposure to European sovereign debt.

MF Global, as a primary dealer, was one of now only 21 financial institutions permitted to participate as a counterparty to the NY Fed's system open market desk that implements the Federal Reserve's daily open market purchases, sales and repurchase operations. As such, MF Global was also obligated to participate as a bidder in US Treasury refunding auctions, and they also, along with other institutions, make a market in such securities. However, MF Global was unique in that it was much more specialized than other primary dealers because it was a financial derivatives specialist, and its business was less diversified and more concentrated than other primary dealers. That in itself should have triggered extra scrutiny when its concentrated risk exposures to European sovereign debt were revealed in its March 10K filing.

The role of primary dealers evolved in a period of time prior to the automation of daily auctions for repurchase agreements and Treasury securities purchases and sales by the System Open Market desk. The system has worked reasonably well, since the primary dealers are supposed to be sound and well-run institutions. Furthermore, because of their size and broad geographical presence,

they can provide initial distribution and liquidity in a reasonably efficient way.

However, this is not the first time primary dealers have experienced some problems. For example, the Fed argued as recently as last year that, when primary dealer Drexel Burnham failed in 1990, its surveillance and monitoring activities enabled it to put in place plans and actions that avoided damage to Drexel's counterparties or the financial system. Yet, in 1992, the Fed abandoned its system for monitoring and surveillance of the activities of individual institution's activities, substituting reliance upon publically available data. The stated reasons for doing so were to change market perceptions that the primary dealers are supervised and examined by the Fed as banks and to limit their perceived franchise value, while reducing any possible incentives to take on more risk because of their privileged position.

The current financial crisis and the Federal Reserve's responses show that, despite the claim, the perceptions that the primary dealers are privileged and treated differently was confirmed. Most of the early emergency liquidity programs that the Fed put into place pursuant to Section 13(3) of the Federal Reserve Act were directed to the few firms that were primary dealers. The programs provided them with substantial subsidies both in terms of low interest rates and ability to borrow high quality securities from the Fed's portfolio to use as collateral in the firms' refinancing activities. Moreover, the Fed did not appear to understand fully the financial distress in these institutions as the crisis emerged, nor did the Fed react swiftly to put in place programs to deal with emerging problems until after the demise of Bear Stearns in March 2008.

The liquidity problems experienced by large numbers of financial institutions demonstrate the danger of relying upon only a few financial institutions as the key providers of liquidity from the Federal Reserve throughout the financial system when those institutions experience financial distress. Some of the key markets essentially shut down and did not function in a way that facilitated the Fed's efforts to restore market confidence and reduce credit spreads. The events of the current crisis confirmed, contrary to the Fed's intention, the fact that the primary dealers were indeed special.

The concerns about systemic risk that surfaced during the crisis led to the creation of the Financial Stability Oversight Council, charged the Federal Reserve to formally address systemic risk, and resulted in restrictions in the Dodd-Frank Act intended to drastically limit the ability of the Fed to come to the aid of individual troubled and/or economically insolvent large systemically important financial institutions in the future. These responses have changed the Fed's policy environment and heightened the need to reevaluate the primary dealer system and the Federal Reserve's monitoring and surveillance activities.

There are two policy options now available to remove primary dealers' special position. The first option is to formally vest the Federal Reserve with examination authority (and perhaps supervisory responsibility in addition to whatever responsibilities are lodged with the SEC or foreign supervisors) for those firms designated as primary dealers. Most of these firms are now supervised by the Fed, so the main impact would be on those primary dealers with foreign parents to whom surveillance and monitoring activities might be extended. The second alternative is the one preferred by the Shadow Financial Regulatory Committee and

upon which we have opined upon in a previous statement (Statement No. 280, December 14, 2009), and that is to eliminate the primary dealer system and bring the whole process of the day to day operations of the Federal Reserve's open market desk into the 21st century by opening the bidding and participation in the auction process to all commercial banks and to investment banks that meet acceptable capital, collateral and prudential standards determined by the Federal Reserve. The revised procedures would provide more direct and likely greater overall liquidity to the secondary market.