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OCTOBER 18, 2005

By Aaron Pressman

What About the Rest of Refco?

Selling the futures brokerage is a solution for only half of the tainted firm's business. The other half is where things could get messy

Now that Refco (RFX) has an agreement to sell its futures brokerage, which is about half its operation, the firm's remaining units are facing rapid liquidation in bankruptcy, people familiar with the firm's restructuring efforts say. And that could leave hedge funds and other big investors scrambling to get their money out (see BW Online, 10/17/05, "Refco's Painful Lesson for Investors").

The once-formidable derivatives broker said late on Monday, Oct. 17, that it had reached a $768 million deal to sell its futures unit, Refco LLC, to a group of investors led by hedge fund J.C. Flowers & Co. Because Refco has more than $1 billion of debt on its balance sheet as of May 31 -- and other creditors like landlords are likely to clamor for the money -- the Flowers deal isn't expected to aid Refco shareholders much, if at all. Goldman Sachs (GS) and boutique investment bank Greenhill & Co. advised Refco. The completion of the deal also marked the end of the assignment for Goldman, which has been criticized for its involvement, given its work as an underwriter on Refco's IPO.

Refco Inc. and some of its remaining units entered Chapter 11 bankruptcy protection and aren't included in the potential Flowers deal, and that's where things could get messy. Refco Capital Markets facilitated trades in foreign currencies and loans backed by U.S. Treasuries. Refco Securities, which did not file for bankruptcy, dealt in stock and bond trading. The parent company has said it's winding down operations at those businesses and imposing a 15-day delay on customer withdrawals from the capital-markets unit.

WILL IT HURT? "It's inevitable [these units] will be placed in bankruptcy, and there will be an auction for whatever is left," says one person familiar with the situation. Refco and Greenhill didn't return calls for comment. Spokesman for Goldman and Blackstone said their firms had no comment.

Whether the freeze will harm any customers is yet to be seen. Hedge funds that borrowed money by putting up Treasury bonds as collateral, a common transaction known as a repurchase agreement, or repo, could be stuck. "It's clearly good news that nothing bad has happened so far, but it doesn't mean that you're out of harm's way," says Leslie Rahl, president of New York-based Capital Market Risk Advisors, which advises financial firms on risk-management practices.

Unwinding trades that went through Refco or those with other brokers that depended on earlier trades that did go through Refco will take time, she added. "I don't think we'll really know until we see the second- and third-order effects. That could easily take several weeks to unravel."

LAYERS OF PROTECTION. No one in the massive repo market has reported any impact yet, according to Robert Toomey, a vice-president at the Bond Market Assn. in New York. "I haven't heard of any problems up until now," he said on the evening of Oct. 17. The securities industry trade group reported that the amount of outstanding repo loans totaled $7.84 trillion at the end of June last year. The market is generally considered extremely safe since all loans are backed by Treasury securities, and no dealers have reported any losses from bankruptcies or defaults since 1990, according to a study that the bond-market group released in January.

Most repo trades go through the Fixed Income Clearing Corp., another layer of protection for investors who dealt with Refco, Toomey said. The nonprofit FICC was created in 2003 as an offshoot of the Depository Trust & Clearing Corp. to reduce risk in the bond markets. "The clearing corporation stands in the middle of trades much the way that the exchanges' clearinghouses do," he said.

Refco's rapid demise, less than a week after the firm announced that its CEO had hidden and then repaid a $430 million debt, has surprised many in the financial-services industry (see BW Online, 10/17/05, "The Family Man Behind Refco's Woes"). But it's no wonder that there's so much interest in the futures half of Refco's business, which helps investors place trades using contracts on exchanges such as the New York Mercantile Exchange and the Chicago Board of Trade. Whatever Refco's financial condition, the exchanges stand in the middle of every trade, avoiding losses if one side should default.

ILL-TIMED IPO? And Refco customer funds invested at the exchanges are segregated from Refco's own balance sheet. As the Chicago

Mercantile Exchange told its members on Oct. 13, Refco's customer funds there are "not subject to any creditor claims against the firm."

In fact, the futures business is growing so rapidly that the Chicago Board of Trade is expected to price an initial public offering for between $45 and $49 a share on Tuesday despite the Refco meltdown. Investors still smarting from their Refco wounds may not be rushing to buy those shares.

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