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UNITED STATES BANKRUPTCY COURT
SOUTHERN DISTRICT OF NEW YORK

In re: MF GLOBAL HOLDINGS LTD., *et al*., Debtors.	Chapter 11 Case No. 11-15059 (MG) (Jointly Administered)

MEMORANDUM OF THE COMMODITY FUTURES TRADING COMMISSION IN RESPONSE TO THE MOTION BY SAPERE WEALTH MANAGEMENT, LLC, *et al.*, TO DIRECT THE DEBTORS' ESTATE TO BE ADMINISTERED PURSUANT TO 11 U.S.C. §§ 761-767 AND 17 C.F.R. § 190

The Commodity Futures Trading Commission ("CFTC" or "Commission") respectfully submits this memorandum of law in response to the Motion by Sapere Wealth Management, LLC, Granite Asset Management, and Sapere CTA Fund, L.P. [collectively "Sapere"] to Direct the Debtors' Estate to Be Administered Pursuant to 11 U.S.C. §§ 761-767 and 17 C.F.R. § 190 (Doc. # 217). Subchapter IV of chapter 7, 11 U.S.C. §§ 761-767, and Part 190, 17 C.F.R. §§ 190.01-10 & appendices, are, respectively, the specialized Bankruptcy Code provisions and CFTC regulations applicable to commodity broker liquidations. Sapere explains that its motion is intended to ensure "priority status to commodities customers to the extent of their segregated accounts at MF Global, Inc. ('MFGI'), a subsidiary of" the primary debtor in this case, MF Global Holdings, Ltd. ("MFG Holdings"). (Doc. # 217 at 1.) The CFTC agrees with certain of the legal propositions stated by Sapere and reaffirms that commodity customers' priority status must be ensured so that all customer property is returned to its rightful owners and may not be used to satisfy the claims of other creditors.

It is not clear, however, that the Court can and should adopt the approach that Sapere suggests in order to protect commodity customers' priority status. As Sapere implicitly acknowledges, subchapter IV and Part 190 by their terms only apply to the liquidation of a commodity broker. Those provisions could also conceivably apply to related entities, but only if certain factual predicates exist – for example, if the Court determined that MFGI was, in effect, the *alter ego* of MFG Holdings. (Doc. # 217 at 6-7.)[1]

The CFTC believes that it may be unnecessary at this juncture to determine whether such a predicate exists, or what the legal effects would be in terms of vicarious liability, because there

[1] Based on the current record before the Court, which is largely undeveloped, the Commission takes no view at this time as to whether the facts would justify the wholesale attribution of MFGI's actions to MFG Holdings. *See also* 7 U.S.C. § 2(a)(1)(B) (providing that agency principles apply under the Commodity Exchange Act in determining whether an act or omission is attributable to a given entity).

are other means available by which to vindicate the priority status of commodity customers. Provisions of the Commodity Exchange Act ("CEA"), Bankruptcy Code and related common law principles provide the trustees and the Court with many tools by which to reclaim customer property and return it to commodity customers, free of other claims. The SIPA trustee should continue to use every means at his disposal to accomplish the goal of 100 percent reimbursement of all commodity customers, and the Chapter 11 trustee, if any such property is under his control, should deliver it to the MFGI estate, forthwith, so that it may promptly be returned.

I. Subchapter IV and Part 190 Do Not Directly Apply to MFG Holdings.

Bankruptcy Code Section 103(d) provides that "Subchapter IV of chapter 7 of this title applies only in a case under such chapter concerning a commodity broker." 11 U.S.C. § 103(d). This provision contains at least two facial obstacles to application of subchapter IV in this proceeding.

First, this proceeding is being conducted under chapter 11 rather than chapter 7 of title 11. Thus, so long as MFG Holdings remains subject to chapter 11 rather than chapter 7, Section 103(d) renders subchapter IV inapplicable. *See also id*. § 109(d) (providing that a commodity broker may not be a "debtor under chapter 11").

Second, the Code defines "commodity broker," in relevant part, as a "futures commission merchant [("FCM")], foreign futures commission merchant, clearing organization, leverage transaction merchant, or commodity options dealer." *Id*. § 101(4). An FCM (the category to which Sapere suggests MFG Holdings belongs (Doc. # 217 at 5-6)), is a person or entity engaged in "soliciting or accepting orders" that, "in connection with" such solicitation or acceptance, also accepts cash, securities, or other property to margin, guarantee, or secure a trade or contract. 7 U.S.C. § 1a(2). Thus, in order to qualify as a commodity broker that is an FCM, the entity

must not only solicit or accept customer funds, but do so in connection with *that entity's* solicitation or acceptance of orders. Thus, if customer funds were solicited and accepted by an FCM and then transferred later to a separate entity, that would not, on its own, be sufficient to bring the separate entity within the definition of FCM or "commodity broker." If MFG Holdings in fact maintained formal separation from MFGI, it is not likely that MFG Holdings would meet the definition of FCM.

If subchapter IV does not apply, Part 190 also does not apply because the key provisions concerning customer property, including 17 C.F.R. § 190.08(a)(1)(ii)(J) cited by Sapere, supplement and clarify subchapter IV.

II. Any Commodity Customer Property Within the MFG Holdings Estate Is Held in Trust and Must Be Returned to Its Owners.

Although the specialized statutes and regulations applicable to commodity broker liquidations do not apply here absent additional determinations by the Court, other provisions of the CEA and the Bankruptcy Code and common law principles would enable the return to customers of customer property transferred improperly from MFGI to MFG Holdings.

Section 4d of the CEA requires that a commodity broker separately account for, and not commingle with other funds, any money, securities, or property the broker receives from a public customer to margin, guarantee, or secure futures or commodity options transactions. 7 U.S.C. § 6d(a)(2). This statute "establishes a specific statutory trust" over such property in the broker's possession as to which the customer is the beneficial owner. *Marchese v. Shearson Hayden Stone, Inc.*, 822 F.2d 876, 878 (9th Cir. 1987); *see also In re Smith*, 72 B.R. 61, 62-63 (N.D. Iowa 1987) ("The Court finds that [Section 4d(a)(2) of] the [Commodity Exchange] Act and regulations created a technical trust[.]").

Trust property, transferred in breach of the trust, remains in trust for the benefit of the beneficiaries, so long as the transferee has knowledge of the breach or of the circumstances that render the transaction unlawful. *See Saltzman v. Commissioner of Internal Revenue*, 131 F.3d 87, 90 (2d Cir. 1997); *Restatement 2d. of Trusts* § 290 (1959) ("If the trustee in breach of trust and as part of an illegal transaction transfers trust property to a person who knows the circumstances which make the transaction illegal, the transferee does not hold the property free of the trust, although he had no notice of the trust."); *id.* § 288 ("If the trustee in breach of trust transfers trust property to a person who takes with notice of the breach of trust, the transferee does not hold the property free of the trust, although he paid value for the transfer."). If Sapere's allegations regarding the actions of MFG Holdings are true (Doc. # 217 at 3 ("MF Global cast aside or destroyed the [segregation] wall, acting for the benefit of the parent (Holdings)"); *id.* at 5 ("[MFG Holdings] utilized its control of [MGFI] to strip from the subsidiary's commodities customers' segregated accounts massive sums."), the Court should find that such property within the MFG Holdings estate remains in trust for the benefit of MFGI commodity customers.

Ordinarily, when such a transfer in breach of trust occurs, "the beneficiary can in equity compel the third person to restore the property to the trust." *Saltzman*, 131 F.3d at 90 (internal quotation marks omitted) (applying New York law). The same is true under the Bankruptcy Code, which provides that the debtor's estate does not include property held in trust for another. *See* 11 U.S.C. § 541(d) ("Property in which the debtor holds . . . only legal title and not an equitable interest . . . becomes property of the estate . . . only to the extent of the debtor's legal title to such property, but not to the extent of any equitable interest in such property that the debtor does not hold."); *United States v. Whiting Pools, Inc.*, 462 U.S. 198, 205 n.10 (1983) ("Congress plainly excluded property of others held by the debtor in trust at the time of the filing

of the petition."). Assets held in trust, therefore, may not be used to pay claims of creditors. *See Pearlman v. Reliance Ins. Co.*, 371 U.S. 132, 135-36 (1962) ("[Bankruptcy law] simply does not authorize a trustee to distribute other people's property among a bankrupt's creditors."); 5-541 *Collier on Bankruptcy* ¶ 541.28 (LexisNexis 2011) ("[A]ssets held in trust will thus normally not be available to the debtor or the debtor's creditors."). If MFG Holdings has possession of trust assets acquired in knowing violation of the statutory trust or otherwise with knowledge of illegality, that property must be returned to the rightful owners free and clear of any other claims against the estate.

The return of funds may be accomplished even if fungible assets such as cash have been commingled such that it is impossible to determine their source as a factual matter. "Equity," under those circumstances, "can serve as a means of attributing rights in such a commingled account by tracing the subsequent payments to particular deposits." *GE Capital Corp. v. Union Planters Bank, NA*, 409 F.3d 1049, 1059 (8th Cir. 2005); *see also FTC v. Bronson Partners, LLC*, 654 F.3d 359, 374 (2d Cir. 2011) ("The rules of tracing 'enable victims to identify particular dollars or assets as the ones they lost.'" (quoting Douglas Laycock, *Modern American Remedies* 673-74 (3d ed. 2002))). For example, when trust funds are commingled with those of a wrongdoer, courts frequently apply "an irrebuttable presumption that," in subsequent withdrawals from the account, the "wrongdoer spends his own money first." *Bronson Partners*, 654 F.3d at 374 (internal quotation marks, alterations omitted). Thus, "as long as the amount in the account exceeds the amount of misappropriated funds that were deposited there, all the plaintiffs' money is still in the account." *Id.* If the account balance drops below the total amount of misappropriated funds, courts typically will conclude that the "lowest intermediate balance" consists entirely of the trust property. *United States v. Coriaty*, 300 F.3d 244, 253 (2d

Cir. 2002); *Restatement of the Law, Restitution* § 212 (1937). Any such property recovered by the SIPA trustee would become customer property pursuant to 17 C.F.R. § 190.08(a)(ii)(D).

Finally, under certain circumstances, it may also be possible to recover customer property transferred to MFG Holdings or related entities, even if such property was subsequently transferred to third parties before the petition date. *See, e.g.*, 11 U.S.C. § 548(a)(1)(A).

Conclusion

The Commission agrees with certain of the general legal principles stated in Sapere's motion as well as the proposition that all customer property, as defined in subchapter IV and Part 190, must be returned to commodity customers free and clear of other claims. The Commission notes, however, that application of these laws as Sapere suggests requires, at a minimum, certain antecedent determinations by the Court, as to which the Commission takes no position at this time. The Commission believes that, at this juncture, it is not clear that the approach Sapere proposes is necessary to vindicate the rights of commodity customers, because the CEA, the Bankruptcy Code, and common law principles provide the Court and the trustees with other means by which commodity customer property can and should be returned to its rightful owners.

COMMODITY FUTURES TRADING COMMISSION

Dated: January 12, 2011
Washington, D.C.

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