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UNITED STATES DISTRICT COURT
SOUTHERN DISTRICT OF NEW YORK

CONOCOPHILLIPS COMPANY, *et al.*, Plaintiffs, v. JAMES W. GIDDENS, Trustee for the SIPA Liquidation of MF Global, Inc., Defendant.	Case No. 1:12-cv-06014-KBF

REPLY BRIEF OF THE COMMODITY FUTURES TRADING COMMISSION IN SUPPORT OF THE TRUSTEE'S MOTION TO CONFIRM

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ConocoPhillips's objection to the Trustee's claim determination has come to depend primarily on persuading this Court to take the extraordinary step of overruling the CFTC's 30-year-old interpretation of its own regulation, established through public notice and comment contemporaneously with the rule. But agency interpretations established in that way are near unassailable, and Plaintiffs fail to cite *even a single case* in which a court has disapproved one.[1] Indeed, courts lack the power to reject an interpretation by an agency of its own rules unless the competing interpretation is "compelled by the regulation's plain language." *Thomas Jefferson Univ. v. Shalala*, 512 U.S. 504, 512 (1994). Far from "compelled," however, Plaintiffs' interpretation here is aberrant – all interested commenters shared the CFTC's interpretation – and ignores key portions of the rules. There is, therefore, no basis for this Court to decline to follow the CFTC's authoritative view. On the other hand, Plaintiffs' alternative theories have receded considerably since the Court agreed to hear this case. Plaintiffs now admit, for example, that Congress did not intend Section 27a to invalidate any existing CFTC regulation – merely to cabin the Commission from *expanded* exercise of regulatory authority. And, while Plaintiffs continue to claim that state law governs, they fail even to cite, much less to address, the statute that preempts state law here. Accordingly, the Court should confirm the Trustee's determination.

I. The Plain Meaning of the Part 190 Rules Supports the Trustee.

1. The Part 190 Rules direct the trustee to "liquidate[]" any letter of credit or other property held by the debtor as margin, 17 C.F.R. § 190.02(f), and to treat the "full proceeds" obtained thereby as "customer property," *id*. § 190.08(a)(1)(i)(E). As the CFTC explained in its opening brief, a letter of credit may be liquidated by drawing it down or otherwise converting it

[1] Counsel for the Commission likewise have not found any such cases. Plaintiffs cite *Christopher v. SmithKline Beecham Corp.*, 132 S. Ct. 2156, 2165 (2012) (interpretation first "announced in an uninvited amicus brief"); *Cuomo v. Clearing House Ass'n*, 557 U.S. 519, 531 (2009) (interpretation announced only in the final release); *Lin v. U.S.*, 459 F.3d 255, 262 (2d Cir. 2006) ("gloss" imposed in adjudication); and *N.Y. Currency Research Corp. v. CFTC*, 180 F.3d 83, 90-93 (2d Cir. 1999) (adjudicatory interpretation where earlier decisions suggested a "contrary reading"), none of which are precedent for what Plaintiffs ask the Court to do here.

to cash. (Doc. No. 33 at 14-15 of 32.) ConocoPhillips simply ignores this and asserts that the rule "says nothing" to suggest that a trustee may do so. (Doc. No. 39 at 17 of 44.) Because Plaintiffs fail to address Rule 190.02(f) in this context, their interpretation is defective on its face.

2. Having ignored the trustee's liquidation power, Plaintiffs posit that the rules require a trustee to do nothing but direct to the customer property estate any margin payments that happen to occur after the bankruptcy filing. But the rules instruct the trustee *not* to do so. Plaintiffs are fundamentally mistaken when they suggest that the only alternatives are to treat margin payments as either "customer property" or "the broker's property." (*Id*. at 24 of 44.) "Customer property" is a defined term encompassing only "property subject to pro rata distribution." 17 C.F.R. § 190.01(n). The rules direct the trustee *not* to divert margin payments to the pro rata pool of customer property, but to credit 100 percent of those funds to the funded balance of the *individual* customer for which the payment was made. *See id.* §§ 190.02(g)(1)(iii)-(2)(iii), 190.07(c)(1)(ii). Plaintiffs' contrary interpretation is not "compelled," but wrong.

Plaintiffs attempt to salvage their interpretation by reference to a separate rule, 190.08(a)(1)(ii)(E), which states that customer property includes "recovery of any debit balance [or] margin deficit," but they appear wrongly to equate a margin *payment* with the recovery of a margin *deficit*. If a customer collateralizes an account with a letter of credit, "the letter of credit itself" serves as margin, *Bankruptcy*, 48 Fed. Reg. 8716, 8718 (Mar. 1, 1983), and no "margin deficit" exists when funds owed are covered by the letter. Such a deficit only exists if there is insufficient collateral *of any kind* in the account to margin open positions or, once the customer's positions are closed, the losses incurred exceed the amount of collateral provided. For example, if the customer posts $1 million in collateral and then loses $1.5 million in trading before the position is closed, there is a "margin deficit" of $500,000. Typically, the clearinghouse would

claim the $500,000 from the FCM's pooled customer account. If the liquidating FCM can recover that margin deficit, the money is customer property, because its restoration is necessary to make other customers whole. If the $1 million in collateral was in the form of a letter of credit, the "full proceeds" would, by definition, be insufficient to address any margin deficit.

Plaintiffs also suggest that "full proceeds" might refer to a hypothetical letter with terms that allow the beneficiary to "draw the *full* proceeds of a letter of credit when only *some* of those proceeds are needed to cure a default." (Doc. No. 39 at 24 of 44.) But, far from "compelled," as would be necessary to upend the CFTC's authoritative interpretation, Plaintiff's theory is inconsistent with the rule text, which states, without such qualification, that the "full proceeds" are customer property so long as "such letter of credit was received, acquired or held to margin, guarantee, secure, purchase or sell a commodity contract." 17 C.F.R. § 190.08(a)(1)(i)(E).

3. While Plaintiffs insist that the "plain language" controls, they nevertheless urge the Court to apply a presumption that the rule codifies only state-law rights. (Doc. No. 39 at 17, 19 of 44.) But *none* of the pro rata distribution requirements in Part 190 or the Bankruptcy Code derive from state law. Plaintiffs cite no state law that would, for example, permit an FCM to liquidate a customer's securities or physical property and distribute the proceeds pro rata – Part 190 requirements indistinguishable from the rule at issue here. Similarly, Plaintiffs argue for a narrow state-law definition of "proceeds" used in the UCC (*id.* at 17-18 of 44), but the CFTC did not adopt that definition in Part 190. Rather, Part 190 uses "proceeds" consistently, *see* 17 C.F.R. §§ 190.04(e)(3), 190.05(a)(3), 190.07(b)(1)(iii)(A)(2), (B)(3), & (e)(1), (4)-(5), in a manner much closer to the *other* definition Plaintiffs quote: "the value of land, goods, or investments when converted into money, or . . . something received upon selling, exchanging, collecting, or otherwise disposing of collateral" (Doc. No. 39 at 17 of 44 (quotation marks

omitted)). The CFTC intended this term to have the same meaning throughout Part 190, which is presumed when an agency uses identical language in related regulations. *Transactive Corp. v. United States*, 91 F.3d 232, 238 (D.C. Cir. 1996). Finally, Plaintiffs argue that "full proceeds" as used by the CFTC would improperly "expand" the estate's property beyond "MF Global's *conditional* right" under state law "to draw on those letters," but they ask the Court to ignore that ConocoPhillips specifically agreed, expressly and by operation of state and federal law, that the CFTC's regulations and interpretations would govern. (Doc. No. 33 at 26-27 at 32.) Plaintiffs now assert that they did not intend to accept *these* regulations and interpretations (Doc. No. 39 at 39 of 44), but the agreements say otherwise (Doc. No. 3-3, ¶ 2 ("*all* applicable regulations"); Doc. No. 3-9 at 11 of 35, ¶1 ("*all* rules and interpretations of the [CFTC]") (emphases added)). Moreover, an agency's interpretation established through notice and comment cannot cause unfair surprise. *Long Island Care at Home, Ltd. v. Coke*, 551 U.S. 158, 170-71 (2007). Thus, ConocoPhillips's state-law rights with respect to these assets and transactions have, from their inception, been subject to and circumscribed by federal law, including Part 190.

4. In light of Plaintiffs' misapprehensions, it is unsurprising that no commenter shared their reading of Rule 190.08(a)(1)(i)(E). While Plaintiffs assert that commenters merely "feared" that the rule would be interpreted as the CFTC does (Doc. No. 39 at 26 of 44), that alone would confirm that Plaintiffs' interpretation is not "compelled" and may not, therefore, be accepted. In fact, however, ConocoPhillips misstates the views of commenters, each of whom read the language just as the CFTC does. (Doc. No. 33 at 9-10 of 32.) Thus, Plaintiffs' interpretation clearly is not "compelled," and the CFTC's interpretation is binding.

II. Section 27a Is Inapplicable.

ConocoPhillips's opposition makes the startling concession that, in the Legal Certainty for Bank Products Act ("Legal Certainty Act"), 7 U.S.C. § 27a, Congress did not alter, but

merely "clarifie[d] what [was] already the current state of the law" in 2000. (Doc. No. 39 at 31 of 44 (quoting 146 Cong. Reg. 27176, 27208 (Dec. 15, 2000) (Sen. Harkin).) This concession disposes of Plaintiffs' Section 27a argument because they can cite no source of law that would have restricted the CFTC from enacting Rule 190.08(a)(1)(i)(E) *before* 2000. Nor does ConocoPhillips dispute that the rule otherwise falls within the CFTC's cited powers. *See, e.g.*, 7 U.S.C. §§ 12a(5), 24(a). Thus, the rule was valid at its adoption in 1983 and remains so today.

1. The Legal Certainty Act was Congress's direct response to a 1998 CFTC release indicating that the Commission "might seek to *exercise regulatory authority* over financial derivatives" transacted by banks, *Derivatives & the Legal Origin of the 2008 Credit Crisis*, 30 Banking & Fin. Svcs. Policy Rep. 13, 18 (2011) (emphasis added) (citing *Over-the-Counter Derivatives*, 63 Fed. Reg. 26114 (May 12, 1998)), including commodity "swaps," as well as some "hybrid instruments" including letters of credit with certain "commodity futures or option characteristics." 63 Fed. Reg. at 26116, 20-21; 12 C.F.R. § 204.2 (a)(1) & (b)(1)(v). The release contemplated that the CFTC might assert regulatory authority over these categories of product by imposing requirements of registration, minimum capital, internal controls, disclosure to customers, personnel supervision, recordkeeping, and financial reporting, much like the regime applicable to futures. 63 Fed. Reg. at 26124-27. Other regulators "question[ed] the scope of the CFTC's jurisdiction in this area,"[2] and Congress reacted swiftly, first, by imposing a six-month "restraint period" in which the CFTC was barred from moving forward. Pub. L. 105-277, § 760, 112 Stat. 2681 (Oct. 21, 1998). Congress stated that the temporary nature of this action should not be construed as "implying a determination that a qualifying hybrid instrument or swap agreement, is subject to the" CEA. *Id*. Soon after, Congress passed the Legal Certainty Act,

[2] *See* Joint Statement by Treasury Sec'y R. Rubin, Fed. Reserve Bd. Chairman A. Greenspan, and SEC Chairman A. Levitt (May 7, 1998), *available at* http://www.treasury.gov/press-center/press-releases/Pages/rr2426.aspx.

including Section 27a, to restrict the CFTC from moving to "exercise regulatory authority under the [CEA]" as the 1998 release described. Thus, as ConocoPhillips concedes, Section 27a did not *reduce* the CFTC's authority or void existing regulations, but simply "clarif[ied] what [wa]s already the current state of the law" in which the CFTC "d[id] not regulate traditional banking products." (Doc. No. 39 at 31 of 44.) Rule 190.08(a)(1)(i)(E), accordingly, was unaffected.

2. This history strongly supports the CFTC's analysis of the phrase "exercise regulatory authority under the [CEA]," to which ConocoPhillips has largely been unable to respond. Under its plain meaning, to "exercise regulatory authority . . . with respect to [a] product," 7 U.S.C. § 27a, is to establish rules of general applicability to that product; to do so "under the [CEA]" is to regulate that product as if it were a future or swap. As the Supreme Court has warned, moreover, such language "cannot be understood if considered apart from the related sections," *Comm'r v. Engle*, 464 U.S. 206, 223 (1984), yet Plaintiffs say nothing to dispute that: (1) the CEA, in several ways, gives content to this phrase that supports the CFTC's reading; (2) Sections 27a(b) and (c) confirm that the statute's function is simply to determine whether a product is or is not subject to the regulatory regime applicable to "swaps" and commodity products; or (3) that placement of the later-revised Section 27a within Dodd-Frank Section 725 underscores Congress's intention merely to foreclose dual regulation of these products as futures or swaps. (Doc. No. 33 at 20-22.) Similarly, while the CFTC pointed out that ConocoPhillips's interpretation may disrupt other aspects of commodity regulation with no Congressional intent to do so, ConocoPhillips responds only with the *non sequitur* that these other provisions "do not affect the basic attributes of a letter of credit." (Doc. No. 39 at 30 of 44.) But they do place additional restrictions on *other* products outside the CFTC's "regulatory authority" within the meaning of Section 27a. (Doc. No. 33 at 24-25 of 32.) And, while ConocoPhillips does not

dispute that the CFTC could altogether *bar* the use of letters of credit as margin, Plaintiffs offer no reason to infer that Congress nevertheless intended to stop the CFTC from *permitting* the practice, subject only to reasonable conditions protecting other customers. (*Id*.)

3. Because the parties agree that Section 27a did not curtail the CFTC's exercise of existing regulatory authority, and Plaintiffs fail to address these other issues, the outcome here does not turn on the applicable level of deference. *See Eastman Kodak Co. v. STWB, Inc.*, 452 F.3d 215, 222 (2d Cir. 2006) (declining to decide whether *Chevron* or *Skidmore* deference applies because "the agency interpretation . . . is persuasive"). In any event, *Chevron* applies. Plaintiffs assert that *Chevron* "is reserved for agency interpretations contained in 'formal adjudications or notice-and-comment rulemaking.'" (Doc. No. 39 at 33 of 44 (quoting *Christensen v. Harris County*, 529 U.S. 579, 587 (2000)).) Even if that were true, *Chevron* would apply here – since Section 27a did not roll back existing CFTC regulations, the operative rulemaking entitled to deference is the 1983 rulemaking adopting the rules pursuant to the CFTC's view of Congress's delegations under, *inter alia*, 7 U.S.C. §§ 12a(5) & 24(a). 48 Fed. Reg. at 8739. But Plaintiffs' contention is not correct – the Supreme Court has confirmed that *Christensen* identified formal adjudications and notice-and-comment rulemakings only as illustrative sources of binding interpretation. *See Barnhart v. Walton*, 535 U.S. 212, 222 (2002) (stating that if *Christensen* "suggested an absolute rule," the Court's "later opinion in *United States v. Mead Corp.*, [533 U.S. 218 (2001)], denied the suggestion"). *Chevron* thus applies more broadly, where Congress has delegated interpretive authority to the agency and the interpretation represents the administrator's "fair and considered judgment on the matter." *Tax Analysts v. IRS*, 117 F.3d 607, 613 (D.C. Cir. 1997) (quotation marks omitted) (*Chevron* deference to interpretation in a brief); *Jones v. Am. Postal Workers Union*, 192 F.3d 417, 427

(4th Cir. 1999) (same); *see Barnhart*, 535 U.S. at 222 (factors for determining if "*Chevron* provides the appropriate legal lens"). Here, in addition to the delegation of plenary power to issue any regulation "reasonably necessary to effectuate" the CEA, 7 U.S.C. § 12a(5), Congress explicitly directed the CFTC to issue regulations establishing procedures for liquidating FCMs and defining what is and is not "customer property," *id*. § 24(a). The rules directing a trustee to liquidate letters of credit and treat the full proceeds as customer property are exactly that. Congress also granted the Commission the right to "appear and be heard on any issue" in an FCM liquidation. 11 U.S.C. § 762(b). The CFTC's interpretation of Section 27a is a fair and considered exercise of this authority (Doc. No. 33 at 17-25), to which deference is owed. *CFTC v. Schor*, 478 U.S. 833, 844 (1986) (cautioning deference to CFTC's view of its plenary power).

III. Federal Law Controls.

1. With respect to preemption, Plaintiffs fail even to cite CEA Section 2(a)(1)(A), which establishes that CFTC regulations supersede state law. *Leist v. Simplot*, 638 F.2d 283, 322 (2d Cir. 1980). Plaintiffs characterize this power as applicable only to "certain narrow categories," but the language they ignore grants the CFTC "exclusive jurisdiction" over all "transactions involving" commodity futures. 7 U.S.C. § 2(a)(1)(A). Plaintiffs' transactions with MF Global, in which they obtained commodity futures in consideration for collateral including letters of credit, plainly were "transactions involving" commodity futures. Put another way, *no* CFTC regulation applies to letters of credit *except* in "transactions involving" CFTC-regulated products. Plaintiffs' argument is, therefore, foreclosed by the plain language of the CEA, and, if there were any ambiguity, the CFTC would be entitled to *Chevron* deference.

2. Instead of addressing the statute, Plaintiffs persist in misstating the Supreme Court's holding in *Wyeth v. Levine* – which has no application here because, there, "Congress ha[d] not authorized the [agency] to pre-empt state law." 555 U.S. 555, 576 (2009). Plaintiffs now assert

that *Wyeth* is a "landmark" establishing a new requirement that federal agencies explain, according to heightened standards, how "state law would impact the federal scheme." (Doc. No. 39 at 36-37 of 44.) But *Wyeth* says no such thing. Rather, in the passage upon which Plaintiffs mistakenly rely, the Court explained that where "Congress *has not authorized* the [agency] to pre-empt state law directly," a court may *nevertheless* find preemption if state law would "pose an obstacle to" Congressional objectives. 555 U.S. at 576-77 (emphasis added). In *that* inquiry, the Court may give "some weight to the agency's views about the impact of [state] law on federal objectives," but only to the extent of the explanation's "thoroughness, consistency, and persuasiveness." *Id.* (quotation marks omitted). That discussion is irrelevant here, because Congress directly authorized the CFTC to preempt state law. 7 U.S.C. § 2(a)(1)(A); H.R. Rep. 93-1383 (1974) (Conf. Rep.), *reprinted in* 1974 U.S.C.C.A.N. 5894, 5897.

3. In any event, the CFTC's analysis here met any applicable standard and addressed the state-law issues that Plaintiffs raise. The Commission reasonably concluded – and Plaintiffs do not dispute – that the rule is necessary to protect customers from unfairly exacerbated injury in the event of a property shortfall, and to ward off the potentially destabilizing effects of increased use of letters of credit as margin. In that discussion, the CFTC *correctly* noted that a bank "cannot refuse to pay" on a letter of credit "based upon nonperformance of an underlying contract." 48 Fed. Reg. at 8718; *see KMW Int'l v. Chase Manhattan Bank*, 606 F.2d 10, 15 (2d Cir. 1979). ConocoPhillips protests that there are exceptions for *fraud*, but, as the Trustee has explained, and the CFTC agrees, a trustee need not and should not make a false certification of default – Part 190 entitles the estate to the full proceeds of the letter without such certification.

IV. The Deadline for Certifying a Default Is Irrelevant to the Trustee's Calculation.

Because the Trustee was not required to certify a default, the instrument's deadline for doing so is irrelevant. Plaintiffs, in fact, have admitted that there is no need here to involve a

bank at all: Asked by the Court whether, depending on the outcome, "there could be a draw[] on the letters of credit," Plaintiffs responded in the negative, explaining that, if it is decided that the "Trustee was entitled to draws," the parties would "allocate the dollars according[ly]" in the Trustee's claim determinations. (9/25/2012 Tr. at 7.) No party asserts any need to draw additional cash into the estate, from the issuing bank or any other source, to satisfy ConocoPhillips's claims to a pro rata share of customer property, much less to do so according to terms for certifying a default that is not a condition of the estate's rights to the property. Nor do Plaintiffs dispute that it would have been futile and wasteful, and for that reason unnecessary, for the Trustee to attempt collection from the bank, because they admittedly would have sought an injunction. (Doc. No. 33 at 30 of 32.) In that context, Plaintiffs resort to mischaracterizing the Commission's adopting release – which they otherwise claim is entitled to "no weight" – as proof that the CFTC meant to *require* a "draw" under all circumstances. (Doc. No. 39 at 40 of 44.) But the partial sentence they quote is excerpted misleadingly: The passage directs the trustee "to draw *the full value* of [the] letter . . . *irrespective of the margin secured thereby*." 48 Fed. Reg. at 8718 (emphases added). Plaintiffs omit the last clause apparently to suggest that the CFTC imposed a requirement of a bank draw rather than, for example, an allocation along the lines that ConocoPhillips itself suggests and admits would be proper, but the passage simply confirms that the "full value" is customer property, not merely the amount securing open positions. Thus, the Trustee should treat each of the letters alike in his calculation of Plaintiffs' allowed claim.

CONCLUSION

For these additional reasons, the Trustee's claim determination should be confirmed.

Respectfully submitted,

COMMODITY FUTURES TRADING COMMISSION

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Dated: December 3, 2012

CERTIFICATE OF SERVICE

I hereby certify that on December 3, 2012, I caused the foregoing document to be served on all counsel via the Court's CM/ECF system.

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