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**UNITED STATES DISTRICT COURT**
**SOUTHERN DISTRICT OF NEW YORK**

| | |
|---|---|
| In re:<br><br>MF GLOBAL Inc.,<br><br>Debtor. | Case No. 1:12-cv-06014-KBF |

**STATEMENT OF THE COMMODITY FUTURES TRADING COMMISSION IN RESPONSE TO CONOCOPHILLIPS' MOTION TO WITHDRAW THE REFERENCE**

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## INTRODUCTION

The U.S. Commodity Futures Trading Commission ("CFTC" or "Commission") has appeared in the proceedings below, pursuant to 11 U.S.C. § 762(b), to assist the bankruptcy court and to express the views of the Commission on laws within the CFTC's jurisdiction. Although the Commission takes no position with respect to which court should decide the Trustee's motion to confirm the determination of ConocoPhillips' claims, the CFTC submits that the following information is relevant to a complete understanding of ConocoPhillips' motion to withdraw the reference and the CFTC regulations cited therein. The Commission will brief in full the issues raised concerning CFTC regulations at the appropriate time in the proper forum.

## DISCUSSION

This dispute concerns the definition and proper treatment of "customer property" in the liquidation of a Futures Commission Merchant (or "FCM"), MF Global, Inc. Specifically, the question presented is whether the full face value of a letter of credit held by the FCM to margin futures trades is "customer property," a term used in Chapter 7 of the Bankruptcy Code and in CFTC regulations to describe assets subject to pro rata distribution among the customers of a bankrupt FCM. *See, e.g.*, 11 U.S.C. §§ 761(10), 766(h); 17 C.F.R. § 190.08. CFTC regulations provide that the full face value of such a letter of credit is, in fact, customer property. *Id*. § 190.08(a)(i)(E). To understand this issue in context, some background is necessary concerning Chapter 7 of the Bankruptcy Code, FCM regulation, and the role of the CFTC.

### I. The CFTC Has Broad Authority to Issue Preemptive Regulations of the Futures Industry.

1. An FCM is an individual or entity that solicits or accepts orders for the purchase or sale of commodity futures. An FCM executes customer trades on an exchange, through a clearinghouse. "Margin" is money, securities, or other property that serves as collateral in a

futures transaction. The customer must deposit margin with its FCM in order to trade, and the FCM must deposit margin with the clearinghouse. Margin functions as a performance bond: If the customer's positions lose value, margin serves to guarantee that the customer will cover the loss. "Initial margin" or "original margin" is the deposit required of the market participant in order to trade, while "variation" (or "variation margin") is a payment that becomes due if the positions lose value. Movants here were commodity customers of MF Global, Inc., who deposited standby letters of credit, rather than cash, as original margin for their trading activity.

2. Futures trading is comprehensively regulated by Congress under the Commodity Exchange Act, 7 U.S.C. §§ 1, *et seq.* ("CEA"), which gives special attention to the treatment and protection of customer property. A key provision is CEA Section 4d, which requires an FCM to segregate and separately account for "all money, securities, and property received by" the FCM, "to margin, guarantee, or secure the trades or contracts of any customer." *Id*. § 6d(a). The purpose of this requirement is to ensure that assets belonging to customers are not vulnerable to risks to the FCM's business.

Congress, in 1974, established the CFTC with a "broad grant of authority" to "regulate the futures trading industry" including "exclusive jurisdiction" over "all futures transactions." H.R. Rep. 93-1383 (1974) (Conf. Rep.), *reprinted in* 1974 U.S.C.C.A.N. 5894, 5897; *see* Commodity Futures Trading Commission Act, Pub L. 93-463, 88 Stat. 1389 (1974).[1] Congress intended that the CEA and all "regulations issued by the Commission" would supersede state law and "preempt the field insofar as futures regulation is concerned." H.R. Rep. 93-1383, 1974 U.S.C.C.A.N. at 5897. The CFTC's powers include not only explicit authority to regulate FCMs, *see*, *e.g.*, 7 U.S.C. §§ 6d(a), 6f(a)-(b), but also the plenary authority "to make or

[1] Today, the Commission's exclusive jurisdiction extends to futures, swaps, and options. *See* 7 U.S.C. § 2(a)(1)(A).

promulgate such rules and regulations as, in the judgment of the Commission, are reasonably necessary to effectuate any of the provisions or to accomplish any of the purposes of the" CEA, *id*. § 12a(5). Those purposes include "to ensure the financial integrity of all transactions subject to" the CEA and "the avoidance of systemic risk," as well as to "protect all market participants from . . . misuses of customer assets." *Id*. § 5(b).

Currently, the CEA and CFTC regulations permit a broad range of property to be used as margin. *See, e.g.*, *id*. § 6d(a)(1) (referring to "money, securities, and property" to be used as margin); 17 C.F.R. § 190.08(a)(i) ("All cash, securities, or other property"). Although the CFTC has expressed reservations about the use of letters of credit as margin, *Bankruptcy*, 48 Fed. Reg. 8716, 8718-19 (Mar. 1, 1983) (stating that "it would be unwise to adopt a policy which would further encourage the use of letters of credit" in this way), and the Commission has broad authority to regulate in this area, 7 U.S.C § 12a(7)(D) (empowering the CFTC to set "margin requirements" to protect the financial integrity of clearing organizations); *id*. § 12a(5) (plenary rulemaking authority), some market participants find the practice useful, and there currently is no prohibition on the use of letters of credit to margin futures and options. *But see* 17 C.F.R. § 39.13(g)(10) (stating that a clearinghouse "shall not accept letters of credit as initial margin for swaps").

## II. Congress, in the Bankruptcy Reform Act of 1978, Delegated to the CFTC General Rulemaking Authority for Commodity Broker Bankruptcies.

1. Soon after Congress established the CFTC, the agency's first Chairman, William Bagley, alerted Congress to the need for bankruptcy reform to "provide specific statutory protection for commodity customers" of failed FCMs and other futures intermediaries. *The Bankr. Reform Act Revision of the Salary Fixing Procedure for Bankr. Judges Adjustment of Debts of Political Subdivisions & Pub. Agencies & Instrumentalities: Hearing on S. 235 & S.*

*236 Before the S. Subcomm. on Improvements in Judicial Mach.* (1975) (statement of Chairman William T. Bagley). Chairman Bagley detailed in a lengthy submission "the unique problems which may be encountered in the event of the failure of" an FCM, among the most serious of which is the potential for a shortfall in margin belonging to customers. *Id*. He noted the disparate ways in which a trustee might address such a shortfall, including: (1) to "attempt to trace and identify, to the extent possible, each asset to a particular customer, and return that asset to such customer"; or (2) to "designate all money, securities, and property traceable or identifiable as belonging to commodity customers in general as a single and separate fund in which the commodity customers of the [FCM] share ratably." *Id*.

The Chairman explained that, in the context of the futures industry, a system of tracing would create serious "inequities." *Id*. While large traders may deposit securities or other forms of property as margin, small traders typically must use cash. *Id*. In the event of a shortfall, "[t]he absolute fungibility of cash oftentimes defies tracing." *Id*. "Consequently, should [an FCM] go into bankruptcy inadequately segregated," the "small cash customers may recover only a small percentage of their investments," while "large investors may recover their entire investments." *Id*. The Chairman, therefore, urged Congress to amend the Bankruptcy Code to provide, *inter alia*, that "[a]ll money, securities, and property received by the bankrupt [FCM] to margin, guarantee, or secure the trades or contracts of customers" should "constitute a single and separate fund" in which "[a]ll commodity customers" would be "entitled to shar[e] ratably." *Id*. This would "eliminat[e] the inequities of specific tracing which unfairly favor the large sophisticated industrial hedger over the small and generally unsophisticated hedger or speculator, who is typically a member of the general public." *Id*.

Congress agreed and, in the Bankruptcy Reform Act of 1978, Pub. L. No. 95-598, 92 Stat. 2549 (1978), established Subchapter IV of Chapter 7 of the Bankruptcy Code, "derived largely from the testimony of Chairman Bagley." H.R. Rep. 95-595, at 271 (1977), *reprinted in* 1978 U.S.C.C.A.N. 5963; *see also* S. Rep. 95-989, at 8 (1978), *reprinted in* 1978 U.S.C.C.A.N. 5787, 5794 (recognizing "unique problems raised by commodity broker bankruptcies" and agreeing that preexisting bankruptcy law was "potentially disruptive" of futures and options markets). Subchapter IV includes a series of specialized provisions applicable only to commodity broker liquidations, *see* 11 U.S.C. §§ 761-767, reflecting a "clear mandate" that courts ensure "customer protection" in those proceedings, *In re Stotler & Co.*, 144 B.R. 385, 392 (N.D. Ill. 1992); *see also* 6-760 Collier on Bankruptcy P 760.01 (LexisNexis 2012) ("The first [objective] is the protection of commodity customers from the effects of an insolvency of a commodity broker.").

2. The linchpin of the Bankruptcy Code's Subchapter IV customer protection regime is Section 766(h), which directs the trustee to distribute all "customer property," on a pro rata basis, in priority to substantially all other claims against the estate:

> Except as provided in subsection (b) of this section, the trustee shall distribute *customer property ratably* to customers on the basis and to the extent of such customers' allowed net equity claims, and *in priority to all other claims*, except claims of a kind specified in section 507(a)(2) of this title that are attributable to the administration of customer property.

11 U.S.C. § 766(h) (emphases added).[2]

At the same time, however, Congress decided against codifying "detailed rules to govern every contingency." S. Rep. 95-989, at 8. Congress recognized the "germinal state of regulation

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[2] The referenced subsection (b) instructs the trustee as to the handling of commodity contracts that remain open and permits the trustee to operate the debtor's business for certain limited purposes. It is not directly relevant to the present dispute.

of the commodities industry" and, therefore, established "only a framework" in Subchapter IV, while delegating "general rulemaking authority" to the CFTC. *Id*. For example, Section 761(10) defines "customer property" to include, among other things, "cash, a security, or other property," that was "received, acquired, or held to margin, guarantee, secure, purchase, or sell a commodity contract." 11 U.S.C. § 761(10). But, Congress granted the CFTC broad discretion to clarify or alter that definition to include or exclude property from pro rata distribution:

> Notwithstanding title 11 of the United States Code, the Commission may provide, with respect to a commodity broker that is a debtor under chapter 7 of title 11 of the United States Code, by rule or regulation—
>
> (1) that certain cash, securities, other property, or commodity contracts are to be included in or excluded from customer property or member property[.]

Bankruptcy Reform Act of 1978, P.L. 95-958 § 302, *codified at* 7 U.S.C. § 24(a)(1). Among other things, Congress also delegated to the CFTC authority to establish "how the net equity of a customer is to be determined," *i.e.*, how to calculate the value of a customer's claim. *Id*. § 24(a)(5).

3. To implement these delegations, the CFTC adopted the "Part 190" rules. *See* 17 C.F.R. §§ 190.01-.10. The rules are a comprehensive set of instructions to a liquidation trustee for administering the bankrupt commodity broker's estate and compensating injured customers. For example, the rules instruct the trustee to liquidate most property in the estate, *id*. § 190.02(f), and to calculate a "funded balance" – that is, each customer's pro rata share of the resulting proceeds, other cash, and property in the estate. With several important caveats not relevant in this overview, the "funded balance" is roughly equal to the product of (1) the ratio of a

customer's net equity claim to (2) all net equity claims in the estate[3] (3) times the total value of property recovered to that estate:

$$\frac{\textbf{Customer's Net Equity Claim}}{\textbf{All Customers' Net Equity Claims}} \times \textbf{“Customer Property”} = \textbf{“Funded Balance” (pro rata share)}$$

The Part 190 rules explain how to calculate each component of this formula. *See id*. §§ 190.07 (net equity), 190.08 (customer property). ConocoPhillips focuses here on the rules for calculating the multiplicand, "customer property."

4. Rule 190.08(a) provides that "customer property" is determined by totaling the value of each of the following, most of which will have been liquidated by the trustee (but, even if not, all of which is subject to pro rata distribution):

> (i) All cash, securities, or other property or the proceeds of such cash, securities or other property received, acquired, or held by or for the account of the debtor, from or for the account of a customer, including a non-public customer, which is:
>
> > (A) Property received, acquired or held to margin, guarantee, secure, purchase or sell a commodity contract;
> >
> > (B) Open commodity contracts;
> >
> > (C) Warehouse receipts, bills of lading, or other documents of title or property held or acquired by the debtor to fulfill a commodity contract;
> >
> > (D) Profits or contractual rights accruing to a customer as the result of a commodity contract;
> >
> > ***(E) The full proceeds of a letter of credit if such letter of credit was received, acquired or held to margin, guarantee, secure, purchase or sell a commodity contract***;

[3] This calculation is performed for each "account class," each of which, the rules provide, "will constitute a separate estate." 17 C.F.R. § 190.08. An "account class" means each of several types of account, including futures accounts, foreign futures accounts, leverage accounts, commodity option accounts, delivery accounts, and cleared over-the-counter derivative accounts. *Id*. § 190.01(a).

(F) Property hypothecated under § 1.30 of this chapter to the extent that the value of such property exceeds the proceeds of any loan of margin made with respect thereto, and

(ii) All cash, securities, or other property which:

(A) Is segregated on the filing date;

(B) Is a security owned by the debtor to the extent there are customer claims for securities of the same class and series of an issuer;

(C) Is specifically identifiable to a customer;

(D) Is property of a type described in paragraph (a)(1)(i)(A) of this section which has been withdrawn and subsequently is recovered by the avoidance powers of the trustee;

(E) Represents recovery of any debit balance, margin deficit, or other claim of the debtor against a customer account;

(F) Was unlawfully converted but is part of the debtor's estate;

(G) Is property of the debtor that any applicable law, rule, regulation, or order requires to be set aside for the benefit of customers, unless including such property in the customer estate would not significantly increase the customer estate;

(H) Is property of the debtor's estate recovered by the Commission in any proceeding brought against the principals, agents, or employees of the debtor;

(I) Is proceeds from the investment of customer property by the trustee pending final distribution; or

(J) Is cash, securities or other property of the debtor's estate, including the debtor's trading or operating accounts and commodities of the debtor held in inventory, but only to the extent that the property enumerated in paragraphs (a)(1)(i)(E) and (a)(1)(ii)(A) through (a)(1)(ii)(H) of this section is insufficient to satisfy in full all claims of public customers.

*Id*. § 190.08(a) (emphasis added). ConocoPhillips protests the inclusion in this sum of "[t]he full proceeds of a letter of credit if such letter of credit was received, acquired or held to margin, guarantee, secure, purchase or sell a commodity contract." *Id*. § 190.08(a)(i)(E). In promulgating the Part 190 rules, however, the Commission considered and rejected similar arguments, reasoning that to exclude letters of credit from the calculation would be (1) inconsistent with equitable, pro rata distribution of customer property; and (2) an incentive to expanded use of letters of credit as margin, which the Commission viewed as undesirable from a policy perspective.

5. The Commission's objectives in creating Part 190 were, among other things, "to promote equitable treatment of customers" and "to enhance certainty as to the effects of a bankruptcy distribution." *Bankruptcy*, 46 Fed. Reg. 57535, 57535 (proposed Nov. 24, 1981). The Commission was aware that certain market participants were depositing letters of credit and various other kinds of property besides cash as margin for futures trades, *id*. at 57539, 57552, and expressed concern that "high-volume or preferred customer[s]" with the wherewithal to do so would "enjoy a status superior to that of other customers in a liquidation." *Id*. at 57538. Accordingly, the Commission proposed that "the full value of a letter of credit posted as margin would be drawn in the event of a bankruptcy and the full proceeds thereof would be treated as customer property." *Id*. at 57553.

Several commenters objected to this provision, arguing that letters of credit should not be included in the calculation of "customer property" because the letters "generally condition payment on delivery of a certification that additional funds are required to margin or to cover a default with respect to a contract." *Bankruptcy*, 48 Fed. Reg. at 8718 (Final Release). The Commission, however, rejected this characterization, noting that "it is the letter of credit itself which is posted as original margin," while the "standby feature," or the ability to present it for payment, "only guarantees the payment of variation margin." Thus, in this context, the letter of credit has an intrinsic value equivalent to the amount of cash for which it can substitute as original margin. (*See, e.g.*, Decl. of Emil A. Kleinhaus, Exs. L&M (ECF Docs. # 3-12, 3-13) (ConocoPhillips account statements listing the face amounts of each letter of credit as components of "Account Value at Market").) The Commission explained that it would therefore be "inherently unfair" to exempt letters of credit from pro rata treatment, because it would "favor large customers at the expense of smaller market participants." 48 Fed. Reg. at 8718. And, if letters of credit were accorded more favorable treatment than other *non*-cash deposits, "there would be substantial incentive to use and accept such letters of credit as margin as they would be a means of avoiding the pro rata distribution of margin funds, contrary to the [Bankruptcy] Code." *Id*.

Such incentive could be destabilizing. The Commission expressed concern about the "viability of such instruments as margin deposits" because letters of credit are comparatively cumbersome to convert to cash in response to a market event. *Id*.; *see also id*. at 8718 n.14 (noting policy changes at some clearing organizations with respect to letters of credit in response to "periods of volatility"). Thus, it would be "unwise to adopt a policy which would further encourage the use of letters of credit and, indeed, their substitution for other forms of margin." *Id*. at 8719. The Commission concluded, therefore, that "customers using a letter of credit to meet original margin obligations" should "be treated no differently than customers depositing other forms of non-cash margin or customers with excess cash margin deposits." *Id*. at 8718. Rule 190.08 was adopted in substantially its current form. *Id*. at 8749-50.

## III. The Legal Certainty for Bank Products Act of 2000 Is Not Relevant.

ConocoPhillips relies in part on the Legal Certainty for Bank Products Act of 2000, Pub. L. No. 106-554, 114 Stat. 2763, which clarifies that a traditional letter of credit is not a future or "swap" subject to CFTC regulation of those products, 7 U.S.C . § 27a(a)(1), but that law is not relevant here.

1. The CEA states that the CFTC has "exclusive jurisdiction" over, *inter alia*, "transactions involving swaps or contracts of sale of a commodity for future delivery." *Id*. § 2(a)(1)(A). The definitions of "commodity" and "swap" are extremely broad. *Id*. §§ 1a(9), 1a(47). A "commodity" includes "all services, rights, and interests . . . in which contracts for future delivery are presently or in the future dealt in." *Id*. § 1a(9). A "swap" includes "any agreement, contract, or transaction . . . that provides for any purchase, sale, payment, or delivery . . . that is dependent on the occurrence, nonoccurrence, or the extent of the occurrence of an event or contingency associated with a potential financial, economic, or commercial consequence." *Id*. § 1a(47).

Absent exclusion, bank products such as letters of credit might qualify as swaps, and, as a result, be subject to a panoply of requirements under the CEA and CFTC regulations. *See, e.g.*, 7 U.S.C. §§ 2(h) (clearing requirement for swaps), 6r (reporting and recordkeeping for uncleared swaps), 6s (registration and regulation of swap dealers and major swap participants); *Business Conduct Standards for Swap Dealers & Major Swap Participants with Counterparties*, 77 Fed. Reg. 9734 (Apr. 17, 2012). The Legal Certainty for Bank Products Act provides such an exclusion, stating that an "identified banking product," such as a letter of credit, is not subject to these laws *unless* a banking agency, in consultation with the CFTC, determines that the product "would meet the definition of a 'swap' under section 1a(47) of the Commodity Exchange Act" and "has become known to the trade as a swap . . . or otherwise has been structured as an identified banking product for the purpose of evading the provisions of" the CEA. 7 U.S.C. § 27a(a). The bank product would then become subject to the full scope of the CEA and CFTC regulation. *Id*.

2. None of this has any bearing on the proper treatment of various kinds of instruments in a commodity broker bankruptcy. The inclusion of letters of credit as customer property, in particular, does not subject those instruments to regulatory requirements under the CEA and CFTC regulations. Much "customer property" under Subchapter IV and Part 190 consists of instruments not subject to the CEA or CFTC regulation, including securities, cash, warehouse receipts, bills of lading, and other documents of title. 11 U.S.C. § 761(10); 17 C.F.R. § 190.08(a)(i). The CEA itself contains explicit provisions that pertain to "identified banking products," without subjecting such products to CFTC "regulatory authority." *See* 7 U.S.C. § 6d(b) (prohibiting misuse of margin property in a deposit account, an "identified banking product" under Section 206 of the Graham-Leach-Bliley Act). Provisions governing the treatment in an FCM bankruptcy of specific types of instruments do not constitute the regulation of those instruments as "products," within the meaning of the Legal Certainty for Bank Products Act.

3. Congress, in the Bankruptcy Reform Act, directed the CFTC to establish a process for dividing the value of all such instruments within a commodity broker bankruptcy estate, pro rata, among injured customers. The Part 190 rules do so in a manner that is fair, efficient, and consistent with Congress's instructions.

## CONCLUSION

The Commission respectfully submits the foregoing to assist the Court in considering ConocoPhillips' motion to withdraw the reference.

Respectfully submitted,

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Dated: August 23, 2012

**CERTIFICATE OF SERVICE**

I hereby certify that on August 23, 2012, I caused the foregoing document to be served on all counsel via the Court's CM/ECF system.

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