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UNITED STATES DISTRICT COURT
SOUTHERN DISTRICT OF NEW YORK

In re: MF GLOBAL INC., Debtor.	Case No. 11-2790 (MG) SIPA
KOCH SUPPLY & TRADING, LP, Plaintiff, v. JAMES W. GIDDENS, Trustee for the SIPA Liquidation of MF Global Inc., Defendant.	Case No. 12 Civ. 5596 (NRB)

REPLY MEMORANDUM OF LAW IN FURTHER SUPPORT OF
MOTION OF KOCH SUPPLY & TRADING, LP FOR SUMMARY JUDGMENT

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KS&T[1] respectfully submits this reply to the Trustee's memorandum of law in opposition to KS&T's Motion for summary judgment (the "**Trustee's Opposition**").

ARGUMENT

In 1983, the CFTC wrote 17 C.F.R. § 190.08(a)(1)(i)(E) to say that the "full proceeds of a letter of credit" are deemed customer property when a commodity broker liquidates. The CFTC contemporaneously interpreted those plain words to mean what they say. Now, the CFTC, having intervened as a party, asks the Court to substitute the words "full proceeds" with the words "face value" to give the regulation an entirely different meaning. The Trustee squarely relies upon this revisionist interpretation in asking the Court to declare, as a matter of law, that (1) the "face value" of the Letter of Credit constitutes customer property, and (2) "KS&T must immediately pay to the Debtor the face value of the [Letter of Credit], $20 million, with interest." Thus, the issue presented to this Court is whether it should permit the revisionist interpretation urged by the CFTC in the context of the specific relief requested by the Trustee.

As to the Trustee's first request, this Court may not defer to an agency's interpretation when, as here, it is inconsistent with the regulation's plain language. *See Lopes v. Dep't of Soc. Servs.*, 696 F.3d 180, 188 (2d Cir. 2012) ("Of course, regardless of the agency's interpretation, the plain meaning of language in a regulation governs unless that meaning would lead to absurd results.") (quotation omitted). As to the Trustee's second request, neither the regulation, as written, nor any other statute or regulation for that matter, imposes any obligation on KS&T to pay money to the Debtor. The Trustee concedes this. (*See* Declaration of Jonathan P. Guy in Support of Koch Supply & Trading LP's Reply ("**Guy Reply Dec.**"), Ex. 1, at 25:15-18 ("If

[1] Capitalized terms that are not defined herein have the meanings set forth in the KS&T's memorandum of law in support of the Motion ("**KS&T's SJ Memo**"), or, if not defined therein, its opposition to the Trustee's cross-motion for summary judgment ("**KS&T's Opposition**").

every other regulatory scheme and statute were in effect except for the 190 regulations enacted by the CFTC, I would concede that we would not be able to do what we are attempting to do here."); Trustee's Opposition, ¶ 11 ("[T]he regulation is silent as to the method of collection . . . .").) Thus, the Court cannot grant either of the Trustee's declarations as a matter of law.

This result is entirely appropriate. The CFTC's revisionist interpretation is not only inconsistent with the regulation's plain language, it also does not reflect the CFTC's fair and considered judgment (coming as it does in the midst of litigation and in direct contradiction of the CFTC's prior interpretation), and would otherwise exceed the agency's delegated authority. *See* 7 U.S.C. § 24(a) (granting the CFTC authority to include "certain cash, securities, [or] other property" within the scope of customer property but not the "face value" of a letter of credit). The Legal Certainty for Bank Products Act also specifically prohibits the CFTC from regulating letters of credit and the CFTC otherwise lacks authority to preempt state law governing expiration dates in letters of credit. Simply put, the CFTC cannot ask this Court to do by way of declaratory judgment what the CFTC does not have the authority to do by itself.

In sum, for the reasons stated in KS&T's SJ Memo, KS&T's Opposition, and this reply, the Court must enter summary judgment in favor of KS&T on the Trustee's Counterclaim and KS&T's own complaint. Nothing in either the Trustee's Opposition or the CFTC's Brief changes that result.

I. KS&T IS ENTITLED TO SUMMARY JUDGMENT ON THE TRUSTEE'S REQUEST FOR A DECLARATORY JUDGMENT THAT THE "FACE VALUE" OF THE LETTER OF CREDIT CONSTITUTES CUSTOMER PROPERTY.

Turning to the arguments in support of the Trustee's First Requested Declaratory Judgment, the Trustee's Opposition contends that the CFTC's revisionist interpretation is "controlling" pursuant to *Auer v. Robbins*, 519 U.S. 452 (1997). But, in expectation of those

arguments, section I of KS&T's Opposition already explained that neither *Auer* deference nor any lesser deference is appropriate. KS&T will not repeat its rebuttal here. Instead, KS&T focuses on arguments raised by the Trustee that were not addressed earlier.

A. The Plain Language of 17 C.F.R. § 190.08 Refers to Letter of Credit "Proceeds," Not "Face Value," and There are No Letter of Credit Proceeds.

KS&T previously demonstrated that the regulation's plain language is dispositive. (KS&T's SJ Memo, at 8-10; KS&T's Opposition, at 13-15.) *See also Koch Supply & Trading, LP v. Giddens (In re MF Global, Inc.)*, No. 12 Civ. 5596, 2012 WL 6134999, at *5 (S.D.N.Y. Dec. 10, 2012) ("Regardless of CFTC intent, the regulation speaks only in terms of 'full proceeds,' and not 'face value.'"). In doing so, KS&T cited to the definition of "proceeds of a letter of credit" in U.C.C. § 5-114(a). The Trustee responds that the "Part 190 Regulations" do not expressly adopt that definition. (Trustee's Opposition, ¶ 19.) KS&T agrees but that does not change the fact that the term "proceeds" refers to actual property (e.g., cash), not an abstract, metaphysical concept of "value." KS&T cited the definition in the U.C.C. (a uniform statute) simply to show that the common-sense understanding of "proceeds" is well-established, as it is. In fact, it is so well-established the CFTC itself relied upon it in its 1983 guidance. Supplementary Information, 48 Fed. Reg. 8716, 8718 (Mar. 1, 1983) (stating that a trustee is required to draw "and treat the *funds received* as customer property") (emphasis added). Thirty years later, the Trustee's own counsel did so in oral argument before this Court (Judge Forrest). (Guy Reply Dec., Ex. 2, at 18:9-11 ("The word 'proceeds' is actually a fairly neutral word; it just means the amount of cash one gets from liquidating an asset."); *id.* at 102:12-14 ("All 'proceeds' means, your Honor, is the cash that the trustee can get when liquidating the letters of credit.").) It is also noteworthy in this regard that throughout the Part 190 regulations the CFTC uses the

terms "proceeds" and "value" differently, belying the Trustee's contention that "proceeds" can be rewritten to say "value." *See, e.g.*, 17 C.F.R. §§ 190.04(e); 190.07(b); 190.08.

Undeterred, the Trustee argues that the plain language—"proceeds of a letter of credit"—should be rewritten, this time to say "the total amount derived from a . . . transaction." (Trustee's Opposition, ¶ 19.) But, even accepting his new definition, it does not follow that the "total amount derived" is the "face value" of the Letter of Credit. On the contrary, the regulation's plain language makes clear that "proceeds of a letter of credit" refers to actual property, not abstract value, which is consistent with the well-established meaning of "proceeds." 17 C.F.R. § 190.08(a)(1) (referring to "cash, securities, or other property").

The Trustee next complains that even if "proceeds" means what it says, KS&T fails to "ascrib[e] any meaning to the modifier 'full'" and "impermissibly asks this Court to view the term 'proceeds' in a vacuum."[2] (Trustee's Opposition, ¶ 16.) But even if the modifier "full" required illumination, it remains the case that the plain language of the regulation says "proceeds," not "value." The Trustee cannot imagine that controlling language away.[3]

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[2] Throughout, the Trustee's Opposition purports to respond to arguments KS&T has not made to divert the Court's attention to an issue in the ConocoPhillips case: whether the Trustee can draw on a letter of credit without an underlying default. But the Court need not reach that issue in this case because the Trustee failed to draw before expiration. (*See* Guy Reply Dec., Ex. 1, at 52:9-13 (Court stating: "I agree with you that it doesn't limit it to the margin obligation existing. But it does say that the trustee has to draw on it. Here the trustee didn't do that.").)

[3] The Trustee also argues that the Court should "consider the broader context of the regulatory scheme as a whole." (Trustee's Opposition, ¶ 9.) However, the broader regulatory scheme provides for the "ratabl[e]" "distribution" of "customer property" "in the form of—(1) cash; (2) the return or transfer . . . of specifically identifiable customer securities, property or commodity contracts; or (3) payment of margin calls." 11 U.S.C. § 766(h). "Customer property" does not include property "to the extent that a customer does not have a claim against the debtor based on such property." 11 U.S.C. § 761(10)(B). It is inescapable that (i) KS&T had no claim against the Debtor simply based on the Letter of Credit and thus neither the Letter of Credit itself nor its "face value" was ever KS&T's "customer property," and (ii) neither the Letter of Credit itself nor its "face value" qualifies as one of the enumerated "forms" in which

B. The "Face Value" of the Letter of Credit is Not a Legally Cognizable Property Interest and, Thus, Does Not Constitute Customer Property.

KS&T also previously demonstrated that the Trustee's substitution of the phrase "face value" for "full proceeds" renders the regulation void in excess of the CFTC's statutory authority in 7 U.S.C. § 24(a). The Trustee responds that the regulation, as interpreted by the CFTC, would be entitled to deference under *Chevron, U.S.A., Inc. v. Natural Resource Defense Council, Inc.*, 467 U.S. 837 (1984). (Trustee's Opposition, ¶¶ 29-46.) But in *Chevron* the Supreme Court states that "[i]f the intent of Congress is clear, that is the end of the matter; for the court, as well as the agency, must give effect to the unambiguously expressed intent of Congress." 467 U.S. at 842-43. Here, 7 U.S.C. § 24(a) unambiguously provides that the CFTC can only include "cash, securities, or other property" as customer property. The metaphysical, abstract concept of "face value" does not fit within any of these categories. (*See* KS&T Opposition, at 14-15.) Thus, the CFTC lacks any authority to promulgate a regulation, under the guise of a revisionist interpretation or otherwise, that includes the "face value" of a letter of credit as customer property. *See* 5 U.S.C. § 706(2)(E) (agency action in excess of its statutory rights is unlawful).

Understanding, albeit belatedly, that the abstract concept of "face value" is not a legally cognizable property interest as required by the regulatory scheme (*see* KS&T SJ Memo, at 11-12; KS&T Opposition, at 13-15), the Trustee is left with no choice but to contradict himself. He argues for the first time that "the 'property' interest at issue" *is not* the "face value" of the letter of credit but rather "the Debtor's right to collect on an undrawn letter of credit." (Trustee's

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(footnote continued from preceding page)

customer property can be distributed. This scheme leaves no doubt that the Trustee was required to promptly "reduce [the Letter of Credit] to cash" in an "orderly" manner "consistent with good market practice" and thus obtain actual proceeds. 11 U.S.C. § 766(f); 17 C.F.R. § 190.02(f)(3). Had he done so, 17 C.F.R. § 190.08(a)(1)(i)(E) would have deemed the "full proceeds" he received (which, under the Letter of Credit's terms, must be cash) to be "customer property."

Opposition, ¶¶ 25-28.) Of course, this new argument is fatal to his declaration that the Letter of Credit's "face value" *is* customer property. Putting that aside, the regulation does not magically turn the *Debtor's* conditional contract rights under the *Debtor's* Letter of Credit into KS&T's customer property. At least when he is before Judge Forrest, the Trustee agrees. (Guy Reply Dec., Ex. 3, at 9 (Trustee's reply brief in ConocoPhillips litigation stating that "the [regulation] does not make [the Debtor's] 'contract right' customer property").)

II. KS&T IS ENTITLED TO SUMMARY JUDGMENT ON THE TRUSTEE'S REQUEST FOR A DECLARATORY JUDGMENT THAT KS&T MUST PAY $20 MILLION TO THE DEBTOR.

As to the Trustee's Second Requested Declaratory Judgment, the Trustee relies primarily on 17 C.F.R. § 190.08(a)(1)(i)(E) and section 362 of the Bankruptcy Code. Section II of KS&T's Opposition already explains why that reliance is misplaced. KS&T therefore only focuses here on additional arguments raised in the Trustee's Opposition.

A. The Trustee's Request is Not Supported by 17 C.F.R. § 190.08.

The Trustee concedes, as he must, that 17 C.F.R. § 190.08(a)(1)(i)(E) "is silent as to the method of collection" but nevertheless argues that the regulation empowers the Trustee "to collect the full value [of the Letter of Credit] from the entity that posted the letter of credit" rather than the issuing bank. (Trustee's Opposition, ¶¶ 3, 11.) The Trustee maintains that the CFTC's Brief properly "interprets" the regulation to permit this because it "does not place any limitation on the party from whom the Trustee may collect." (Trustee's Opposition, ¶ 12.) As a threshold matter, the CFTC's Brief actually says that the Trustee can obtain the proceeds from the Issuing Bank or, *by agreement*, from the customer. (*See* KS&T's Opposition, at 27-29; *see also* Guy Reply Dec., Ex. 1, at 53:14-16 (CFTC's counsel defending position in its brief by stating: "I don't think anybody would dispute that it would be appropriate for the trustee to take

what cash he got *by agreement* with the customer and distribute it pro rata.") (emphasis added).) More fundamentally, though, the Trustee ignores the Supreme Court's instruction that interpretation of a regulation "is warranted only when the language of the regulation is ambiguous." *Christensen v. Harris County*, 529 U.S. 576, 588 (2000). When a regulation is silent, the agency is prohibited, for obvious reasons, from rewriting the regulation by guise of interpretation. *Id.* at 587-88 (finding regulation that "does not address the issue of compelled compensatory time" is "not ambiguous on the issue of compelled compensatory time" and thus rejecting agency's interpretation). Here, because the regulation is "silent as to the method of collection," and not ambiguous, there is no legal basis for the Trustee's proposed interpretation.

The Trustee's interpretation is also forestalled by the plain language of the regulation, which requires the Trustee to obtain "proceeds *of a letter of credit*," not from some other source. As Judge Forrest recognized during recent oral argument, the Trustee's position that money obtained from KS&T in this case would be proceeds of the Letter of Credit rests on a "fiction." (Guy Reply Dec., Ex. 2, at 22:21-15 ("[I]f it turns out that [the letter of credit] expired, and the only thing you can do is go after [the customer] with another lawsuit, I really don't know that we're talking about a letter of credit. It's almost like a fiction; it no longer exists."); *see also id.* at 21:18-22 ("[The regulation] includes letters of credit, which one would think of as existing live letters of credit, not substitutes for them in terms of claims on the company or some other thing. There would need to be different language."). The Trustee cannot excise the words "of a letter of credit" from the regulation any more than he can excise the word "proceeds."

Additionally, the Trustee's interpretation is inconsistent with the CFTC's original interpretation and would impose a new $20 million liability on KS&T without fair notice. *Cf. Christopher v. Smithkline Beecham Corp.*, 132 S.Ct. 2156, 2166 (2012) (explaining that

deference to an agency's interpretation may not be appropriate "when [it] conflicts with a prior interpretation"); *id.* at 2167 ("Petitioners invoke the [agency's] interpretation of ambiguous regulations to impose potentially massive liability on respondent for conduct that occurred well before that interpretation was announced. To defer to the . . . interpretation in this circumstance would seriously undermine the principle that agencies should provide . . . fair warning of the conduct a regulation prohibits or requires.") (quotation omitted). Indeed, the CFTC's original interpretation stated that the Trustee was required to "draw" on the Letter of Credit, and thus collect from the Issuing Bank.[4] Supplementary Information, 48 Fed. Reg. 8716, 8718 (Mar. 1, 1983). Had the Trustee done so, KS&T would not have had a reimbursement obligation. (Declaration of Rodger Lindwall in Support of Koch Supply & Trading, LP's Opposition to Trustee's Motion for Summary Judgment, ¶ 5.) And it is undisputed that KS&T did not breach any obligations to the Debtor. (SUF, ¶ 11.) Thus, KS&T had no notice that the Trustee, or any other entity, would claim against it for $20 million on account of the Letter of Credit.

In the end, the Trustee gets the analysis exactly backwards. Under state law, the Debtor could only collect on account of the Letter of Credit from the Issuing Bank. *See New England Dairies, Inc. v. Dairy Mart Convenience Stores, Inc. (In re Dairy Mart Convenience Stores, Inc.)*, 351 F.3d 86, 91 (2d Cir. 2003) (stating that a letter of credit only creates "a conditional claim on the assets of the bank"). Thus, the relevant question is not whether the regulation "places a[] limitation on the party from whom the Trustee may collect," as the Trustee suggests, but whether the plain language of the regulation overrides state law and gives the Trustee a new

[4] As the Court has recognized, "it is unclear from the CFTC['s] [c]ommentary how the Trustee could 'draw' on an expired, undefaulted letter of credit." *Koch Supply & Trading*, 2012 WL 6134999, at *6. (*See also* Guy Reply Dec., Ex. 3, at 9 (Trustee stating that "neither the regulation nor the [CFTC's commentary] addresses what occurs if a [letter of credit] expires"); *id.*, Ex. 2, at 55:5-8 (CFTC's counsel stating that "there is nothing in the rule specifically or in the supplemental information that deals with the issue of expiration").)

right to collect from KS&T. By the Trustee's own admission, it does not. Nor could it. Congress did not authorize the CFTC to create such a cause of action. 7 U.S.C. § 24(a) (granting CFTC authority to supplement the definition of customer property only by "includ[ing] or exclud[ing]" "cash, securities, [or] other property," not by creating new property rights).

B. The Trustee's Request is Not Supported by 11 U.S.C. § 362.

Last, the Trustee's Opposition relies on section 362 of the Bankruptcy Code, asserting that "KS&T is now in possession of *customer property* in violation of the automatic stay." (Trustee's Opposition, ¶ 47 (emphasis added).) But section 362 only applies to "property of the estate," which is defined by section 541 of the Bankruptcy Code and focuses on the Debtor's interests; it does not apply to "customer property," which is defined by section 761(10) of the Bankruptcy Code and 17 C.F.R. § 190.08(a)(1) and focuses on the customers' interests. The Trustee fails to recognize this distinction or appreciate that even if the "face value" of the Letter of Credit were "customer property" (it is not), it does not follow that it is "property of the estate." (*See* KS&T's Opposition, at 31 n. 21). This failure is curious because the Trustee argues strenuously to Judge Forrest that, for property of the estate, "the relevant analysis looks to the debtor's state law property rights," whereas customer property "focuses not on the debtor's interest but instead on whether or not the customer had a claim to the property." (Guy Reply Dec., Ex. 3, at 5 (Trustee's reply brief in ConocoPhillips case).); *see also* Guy Reply Dec., Ex. 2, at 26:4-12 (Trustee's counsel making same argument at a hearing before Judge Forrest).) Of course, under state law, the "face value" of the Letter of Credit is not "property of the estate" because the only legal interest that the Debtor had was a conditional right to collect payment from the Issuing Bank prior to expiration. (*See* KS&T's Opposition, at 30-32.) To be sure, the Trustee, in one of his contradictory arguments, does contend that the property interest at issue is

that conditional right, *see* section I.B. *supra*, but this new contention only undermines the Trustee's reliance on section 362 of the Bankruptcy Code because it is undisputed that KS&T was never in possession of the Debtor's conditional rights under the Letter of Credit.[5]

CONCLUSION

For all of the reasons set forth in KS&T's SJ Memo, its Opposition, and herein, KS&T respectfully reiterates its request that the Court grant the Motion and the relief requested therein.

Dated: January 7, 2013
Washington, D.C.

Respectfully submitted,

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[5] The Trustee's inability to either fashion a coherent, consistent legal position or not contradict himself, both within this case and as compared to the ConocoPhillips litigation, demonstrates why the position he advances—KS&T must pay $20 million to the Trustee in connection with the expired Letter of Credit and receive no distribution on that "customer property"—is not colorable. In the end, the Trustee falls back on his equities argument: that other customers are only receiving a tiny recovery. That, of course, is no support at all for a declaration as a matter of law. Moreover, as the Trustee has known all along, because of information he is privy to, his "tiny recovery" representation was, and is, false. Rather, those other customers stand to receive a full recovery, a subject on which the Trustee is now understandably coy, at least before this Court. (*See* Guy Reply Dec., Ex. 4 (Louis J. Freeh, Chapter 11 Trustee, stating: "It is my belief, however, based upon currently available public data in the United States and reports issued by affiliates and administrators around the world that . . . all of the customers of [the Debtor] eventually will be made whole by the [Trustee]."); *see also* Motion Pursuant to Federal Rule of Bankruptcy Procedure 9019 for Entry of Order Approving Settlement Agreement Between the Debtor, the Trustee, MF Global UK Limited (In Special Administration) and MFGUK Joint Special Administrators, Case No. 11-2790, ECF No. 5168, ¶ 1 (filed December 21, 2012) (announcing settlement that, upon approval, will "allow for a prompt influx of several hundred million dollars to the [the Debtor's] estate primarily for the benefit of [the Debtor's] former commodities customers who traded on foreign exchanges").)