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UNITED STATES DISTRICT COURT
SOUTHERN DISTRICT OF NEW YORK

In re MF GLOBAL INC., Debtor.	Bankruptcy Case No. 11-2790 (MG) SIPA
CONOCOPHILLIPS COMPANY, et al., Plaintiffs, v. JAMES W. GIDDENS, Trustee for the SIPA Liquidation of MF Global Inc. Defendant.	Case No. 12-CV-6014 (KBF)

REPLY MEMORANDUM IN FURTHER SUPPORT OF THE TRUSTEE'S AMENDED MOTION FOR AN ORDER CONFIRMING THE TRUSTEE'S DETERMINATION OF CONOCOPHILLIPS' CLAIMS TO CUSTOMER ACCOUNTS MARGINED WITH LETTERS OF CREDIT

TABLE OF CONTENTS

Page

TABLE OF AUTHORITIES

TABLE OF AUTHORITIES
(Continued)

Page(s)

STATUTES AND RULES

REGULATIONS

LEGISLATIVE AND ADMINISTRATIVE MATERIALS

OTHER AUTHORITIES

PRELIMINARY STATEMENT

Prior to the liquidation of MF Global Inc. ("MFGI"), ConocoPhillips, like all other former MFGI customers, posted margin to secure its trading activity. Unlike other customers, ConocoPhillips, because it used letters of credit ("LOCs") as margin rather than cash or securities, argues for the return of its margin outside the Bankruptcy Code's normal pro rata distribution process. As demonstrated in the opening papers by the Trustee ("Trustee's Mem.") and the Commodity Futures Trading Commission ("CFTC Br."), the CFTC anticipated exactly this situation as early as 1981. And it promulgated a regulation (17 C.F.R. § 190.08(a)(1)(i)(E)) or the "LOC Provision") explicitly to foreclose ConocoPhillips' position, emphasizing that all customers, large and small, should be treated the same in a futures commission merchant ("FCM") liquidation.

In its opposition brief ("Opp. Br."), ConocoPhillips argues that the CFTC promulgated a regulation inadvertently directing a result exactly opposite from its explicit intent. Sidestepping legislative history and statutory construction principles, ConocoPhillips argues that Congress, in unrelated legislation, abrogated the LOC Provision without mentioning it. ConocoPhillips also argues that state LOC law trumps the CFTC's regulation, despite Congress' specific direction that the CFTC promulgate customer property regulations. Finally, ConocoPhillips argues that, even if the LOCs are customer property, the property evaporated when some of the LOCs expired.

ConocoPhillips is incorrect. The bedrock principle of ratable distribution in bankruptcy – codified in 11 U.S.C. § 766(h) in the context of a FCM liquidation – as well as the plain language and history of the relevant laws contravene its arguments.

ARGUMENT

I. THE CFTC SAID WHAT IT MEANT IN THE LOC PROVISION.

ConocoPhillips' argument is premised on its contention that the CFTC promulgated a regulation that, inadvertently but also clearly and unambiguously, says exactly the opposite of what the CFTC intended. The language and intent of the LOC Provision belie such a reading. The CFTC articulated what it intended the LOC Provision to mean when it proposed the provision in 1981 prior to notice and comment. The commentators understood exactly what the provision meant during the notice and comment period. The CFTC reiterated the meaning of the LOC Provision in 1983 when it promulgated the final regulation. Subsequent commentators recognized the correct meaning of the regulation.[1] And the CFTC remains consistent in its interpretation today.

The LOC Provision makes the "full proceeds" of a LOC customer property. 17 C.F.R. § 190.08(a)(1)(i)(E). The plain language supports the Trustee's position: "full proceeds" means that LOCs, when posted as margin with a FCM, should be fully available as customer property subject to pro rata distribution by the Trustee. (See Trustee's Mem. at 9-10.) This plain meaning has been apparent for over thirty years.

ConocoPhillips' argument – that the plain meaning supports it and that the purpose, history, and CFTC interpretation of the LOC Provision should all be ignored – is incorrect. First, the argument is not supported by case law. From the Supreme Court down, courts have recognized that the "plain language" of a statute or regulation should not be read in a manner contrary to the intent of the drafter or to reach absurd results. See United States v. Ron

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1. See William F. Teuting & Christoper Q. King, Funds Protections: An Overview of What Happens When a Commodity Broker Becomes Insolvent, 7 J. of Futures Markets 93, 98 (Winter 1987).

Pair Enters. Inc., 489 U.S. 235, 242 (1989); Chechele v. Elstain, No. 11 Civ. 3320 (SAS), 2012 U.S. Dist. LEXIS 23975, at *6 (S.D.N.Y. Feb. 24, 2012). ConocoPhillips' proposed reading of the regulation would be contrary to and clearly frustrate the CFTC's intent. 48 Fed. Reg. 8716, 8718 (Mar. 1, 1983).

Second, the "plain language" of the LOC Provision does not say what ConocoPhillips would like it to say, and it certainly does not do so unambiguously. ConocoPhillips argues that the CFTC should have written "full face amount" rather than "full proceeds" to achieve the outcome it clearly intended. But this is a false dichotomy. The term "proceeds" has its usual meaning of "something that results or accrues; the total amount derived from a sale or other transaction." (CFTC Br. at 10.) Certainly, "full proceeds" does not equal "amount that could have been drawn down pre-petition, pursuant to state law, to remedy a customer default." These additional words, which ConocoPhillips argues the Court should insert into the LOC Provision as its unambiguous plain meaning, actually defeat the provision's purpose. For all of the LOCs involved in the MFGI liquidation, there was no customer default, meaning that the LOC Provision would bring no customer property into the estate where MFGI had actually permitted over $270 million in LOC margin to be posted by its customers. This result would provide a windfall to some customers, while depriving the others of customer property that the CFTC's regulatory framework always contemplated would be available for distribution to them.

Moreover, a "default" is consistently not required for any type of margin to become customer property. 17 C.F.R. § 190.08(a)(1)(i)(A). Any former MFGI customer could argue, like ConocoPhillips, that MFGI had no pre-petition state law right to access the margin it had posted absent a default. But in a FCM liquidation, there is no dispute that the Trustee is charged with distributing all margin to customers ratably. Inserting a "default" requirement only for margin posted as LOCs would prefer the nine former MFGI customers that used LOCs over the tens of thousands that did not. The LOC Provision certainly does not unambiguously mandate this inequitable result.

Third, regardless of how one reaches the LOC Provision's promulgation history – whether because the alleged "plain language" of a regulation cannot be interpreted in a vacuum or because the LOC Provision does not unambiguously say what ConocoPhillips argues, or both – there is no dispute that history supports the Trustee's determination. The CFTC's current interpretation is also entirely consistent with its contemporaneous intent. And the CFTC's longstanding, consistent interpretation of its own regulation is entitled to deference. (See Trustee's Mem. at 10-13); see also Green Island Power Auth. v. Fed. Energy Regulatory Comm'n, No. 11-1960, 2012 U.S. App. LEXIS 20048, at *2-3 (2d Cir. Sept. 25, 2012).

II. THE LOC PROVISION IS A VALID EXERCISE OF THE CFTC'S CLEARLY DELEGATED AUTHORITY.

ConocoPhillips dedicates only a few pages to its incorrect reading of the LOC Provision. Instead, it predominantly argues that other state and federal laws somehow invalidate the LOC Provision. They do not. ConocoPhillips' arguments all must be considered in the context of the statute in which Congress granted the CFTC the authority to promulgate the LOC Provision in the first place – a statute that ConocoPhillips ignores in its opposition:

> Notwithstanding Title 11, the [CFTC] may provide, with respect to a commodity broker that is a debtor under chapter 7 of Title 11, by rule or regulation . . . that certain cash, securities, other property or commodity contracts are to be included in or excluded from customer property. . . .

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7 U.S.C. § 24(a)(1) (emphasis added). This delegation of authority to the CFTC to make rules about customer property in a FCM liquidation could not be more explicit. ConocoPhillips' arguments that other, unrelated laws withdraw that authority should not be accepted.

A. The Bankruptcy Code Provisions Cited By ConocoPhillips Are Not Relevant To This Dispute.

ConocoPhillips argues that two Bankruptcy Code provisions – 11 U.S.C. § 541(a)(1) and 11 U.S.C. § 766(f) – prohibit the LOC Provision as promulgated. They do no such thing. First, ConocoPhillips argues that, in the creation of the debtor's estate under 11 U.S.C. § 541(a)(1), the relevant analysis looks to the debtor's state law property rights. In a typical bankruptcy, this is undoubtedly true. But this is a FCM liquidation. There is a separate subchapter of the Bankruptcy Code that governs such liquidations, particularly to address customer property. That important distinction shifts the question here to whether the LOCs are "customer property," not whether they were property in which the pre-petition debtor had a state law property interest.

The statutory definition of customer property supports this; it focuses not on the debtor's interest but instead on whether or not the customer had a claim to the property. E.g., 11 U.S.C. § 761(10)(A)(ii); 11 U.S.C. § 761(10)(B) (excluding from customer property any property to which the customer would not have a claim).[2] Indeed, ConocoPhillips' misplaced argument based on section 541(a) was advanced in the Madoff liquidation and rejected. See SIPC v. Bernard L. Madoff Inv. Sec., LLC, 401 B.R. 629 (Bankr. S.D.N.Y. 2009), aff'd sub

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2. See also H.R. Rep. No. 95-595, at 391 (1977), reprinted in 1978 U.S.C.C.A.N. 5963, 6347 (explaining that the purpose of this subparagraph is to "[e]xclude[] property in a customer's account that belongs to the commodity broker, such as a contract placed in the account by error, or cash due the broker for a margin payment that the broker has made").

nom. Rosenman Family, LLC v. Picard, 420 B.R. 108 (S.D.N.Y. 2009), aff'd, 395 F. App'x 766 (2d Cir. 2010).[3]

Second, ConocoPhillips argues that any draw down on the LOCs would have been unlawful and violated the "good market practice" reference in 11 U.S.C. § 766(f). But as we know, no "unlawful" draw down was ever contemplated. Had a Trustee draw been necessary – and one never was, as the Trustee reached interim or final agreement with all LOC customers – the demand on the bank would have been accurate and clear that it was pursuant to CFTC regulation. It is difficult to fathom that, by following explicit CFTC instructions, the Trustee's actions would fall outside good market practice. Indeed, "good market practice" as used in this statute has nothing to do with LOCs at all; rather, it was meant to prevent a trustee "from flooding a thin market with a large percentage of share in any one issue." S. Rep. No. 95-989, at 102 (1978), reprinted in 1978 U.S.C.C.A.N. 5787, 5888.

B. The Legal Certainty For Bank Products Act Did Not Abrogate The LOC Provision.

ConocoPhillips argues that the Legal Certainty for Bank Products Act of 2000 ("LCBPA") abrogated the almost twenty-year-old LOC Provision, even though neither the LCBPA itself nor any of its legislative history mentions the LOC Provision at all.

ConocoPhillips premises its argument on its contention that the LCBPA "unequivocally prohibits the CFTC from promulgating a rule that would alter the terms and characteristics of a letter of credit." (Opp. Br. at 18.) This argument suffers from three flaws. First, the statute does not refer to altering the terms of a LOC. Rather it states that the CFTC

3. Rosenman Family, LLC's rejected argument is reproduced at Brief for Plaintiff-Appellant Rosenman Family, LLC, Rosenman Family, LLC v. Picard, 395 F. App'x. 766 (2d Cir. 2010) (No. 09-5296) ("[T]he SIPA statute is intended merely to create a priority class of creditors within the bankruptcy framework, and they are only entitled to property in which their broker had a legal or equitable interest.")

"shall not exercise regulatory authority under the [CEA] with respect to" a series of traditional banking products like savings accounts, certificates of deposit, and LOCs. 7 U.S.C. § 27a(a)(1) (emphasis added). The most reasonable plain meaning of "regulatory authority under the [CEA]" is the CFTC's well-known, historical, and thorough regulation of the commodity futures markets. (See CFTC Brief at 15.) A bank does not become subject to this extensive regulation simply by issuing a LOC any more than it does by loaning cash that could be used as margin.[4]

Second, ConocoPhillips overstates the effect of the LOC Provision when it argues that the provision alters the terms and characteristics of a LOC. The only effect that the LOC Provision has on a LOC is to bring its full proceeds into the customer property estate in a FCM liquidation. It also notifies customers and banks how LOCs posted as margin for commodity futures trading will be treated in the event of a FCM liquidation: pro rata, exactly like all other forms of margin.

Third, it is at the very least not clear and unambiguous that Congress intended in the LCBPA to abrogate the LOC Provision. Given this ambiguity, the CFTC's interpretation – as the agency charged with administering the statute – is highly persuasive. ConocoPhillips' assertion that agency deference is only warranted when the agency's interpretation has gone through formal notice and comment is simply not the law. See Kruse v. Wells Fargo Home Mortg., Inc., 383 F.3d 59, 59-61 (2d Cir. 2004); see also WPIX, Inc. v. ivi, Inc., 691 F.3d 275, 283-85 (2d Cir. 2012). Even the cases cited by ConocoPhillips support deference to the agency's interpretation. See Conn. Office of Prot. & Advocacy for Persons with Disabilities v. Hartford Bd. of Educ., 464 F.3d 229, 239 (2d Cir. 2006) (deferring to agency's interpretation under

4. Legislative history supports this: Congress wanted to reiterate the existing state of the law by providing "certainty that products offered by banking institutions will not be regulated as futures contracts." 146 Cong. Rec. 27237 (2000) (emphasis added); (see Trustee's Mem. at 20-21; CFTC Br. at 14-15.)

Skidmore); Estate of Landers v. Leavitt, 545 F.3d 98, 106 (2d Cir. 2008) ("[L]ess formal, nonlegislative interpretations" are not "disqualified from receiving Chevron deference.").

C. The U.C.C. Does Not Trump Federal Regulations.

ConocoPhillips' final "other laws" argument is that state contract law trumps the correct application of the CFTC regulation. But federal regulation in the commodity futures and bankruptcy fields is pervasive, and there is no question that the controlling rule is the federal one.

First, ConocoPhillips argues that any CFTC interference with state laws governing LOCs is impermissible because Congress did not give the CFTC preemptive authority. (See Opp. Brief at 25.) There is no dispute that "[p]re-emption fundamentally is a question of congressional intent." English v. Gen. Elec. Co., 496 U.S. 72, 78-79 (1990). Here, Congress' intent that the CFTC promulgate rules governing what is and what is not customer property is clear. See 7 U.S.C. § 24(a)(1). With such an explicit grant of authority, Congress did not need to specifically mention the preemption of state laws, including U.C.C. provisions.

Second, ConocoPhillips' proposal that state law governs customer property conflicts with Congress' stated intent to create a "cohesive policy for guidance" in a FCM liquidation. S. Rep. No. 95-989, at 7 (1978), reprinted in 1978 U.S.C.C.A.N. 5787, 5793. ConocoPhillips is unable to cite a single case that limits the definition of customer property by reference to state law. Butner v. United States, the seminal bankruptcy case cited by ConocoPhillips, addressed the debtor's interest in property, not customer property. See 440 U.S. 48, 54-55 (1979). And even in that context, Butner recognized that an overriding federal interest would trump state law. See id.; see also SIPC v. Bernard L. Madoff Inv. Sec. LLC (In re Madoff Sec.), 476 B.R. 715, 724-28 (S.D.N.Y. 2012) (citing to Butner and holding that "[n]either bankruptcy law nor state law require the Court to disregard SIPA . . .").

Third, ConocoPhillips draws a false distinction between the LOC Provision and its accompanying Supplementary Information. Whether the Supplementary Information, standing alone, would have preemptive effect is not the question here. It is the regulation itself, properly interpreted, that must be given effect. And the only correct interpretation of the regulation is that, when a LOC is used to margin futures trading, the full value of that LOC becomes customer property in a FCM liquidation.[5]

III. CUSTOMER PROPERTY CANNOT DISAPPEAR WHEN LETTERS OF CREDIT EXPIRE.

ConocoPhillips' final argument is that even if the LOCs were customer property, the property goes away when the LOCs expire. The resulting windfall would defeat the LOC Provision's purpose and should not be expected by any customer. (See CFTC Brief at 24-25.) ConocoPhillips' general premise that "when the contract expires, the right is lost," does not address the treatment of LOCs-as-margin in a FCM liquidation; the LOC Provision does that. (Opp. Br. at 30.) And the LOC Provision does not make a "contract right" customer property; it directs that customer property includes a LOC's "full proceeds."

As ConocoPhillips points out, the Supplementary Information (which ConocoPhillips otherwise urges the Court to ignore) contemplates that a trustee will draw on LOCs. But neither the regulation nor the Supplementary Information addresses what occurs if a LOC expires. To fill this gap, the Court should consider the economic reality of commodity futures margining, the LOC Provision's purpose, and the CFTC's interpretation. See In re Bernard L. Madoff Inv. Sec. LLC, 654 F.3d 229, 237-38 (2d Cir. 2011).

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5. Because the regulation (and not just the Supplementary Information) is controlling here, Wyeth v. Levine is not relevant. 555 U.S. 555, 577-78 (2009). Wyeth is also distinguishable because the CFTC did provide a detailed and reasoned explanation of its consistent longstanding view, and that view is consistent with Congress' purposes. See id.

First, the economic reality: LOCs and cash or other assets work the same way when used as margin. In either case, the customer is the ultimate source of the funds. For cash collateral customers, the cash is withdrawn from an account. For LOC customers like ConocoPhillips, the funds are initially drawn from the issuing bank, but that same day, ConocoPhillips would be obligated to reimburse the bank. See U.C.C. § 5-108(i)(1). If a LOC had expired pre-petition, ConocoPhillips would have been under-margined, and, just as with any other customer, additional margin would have been required. (See Trustee's Mem. at 4.) Given the similarity pre-petition, there is no reason for different, more favorable treatment for LOCs post-petition. The expiration (or return) of a LOC is just like the return of any collateral, and it is subject to the same pro rata distribution principles. (See Trustee's Mem. at 13-15.)

Second, the LOC Provision's goal is to ensure equitable treatment for customers posting margin regardless of form. (See supra section I.) If the customers posting LOCs can receive a windfall (i.e. the complete return of their margin in the event of an expiration) the purpose of the regulation is frustrated. (See CFTC Br. at 24-25.)

Finally, the CFTC made its interpretation of its regulations clear: the expiration of the LOCs does not affect their status as customer property. (See CFTC Br. at 24-25.) That interpretation is consistent with both the language and the purpose of the regulation, and it is entitled to deference. See Talk Am., Inc. v. Mich. Bell Tel. Co., 131 S. Ct. 2254, 2263 (2011) ("[N]ovelty alone is not a reason to refuse deference."); (See CFTC Br. at 20.)

CONCLUSION

For the foregoing reasons, the Trustee's determination of ConocoPhillips' claims to customer accounts margined with LOCs should be confirmed.

Dated: December 3, 2012
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