When is an Unregulated Derivatives Dealer Considered to be a "Stockbroker" for Purposes of the Bankruptcy Code?

*by Paul B. Uhlenhop**

In the Chapter 11 proceeding in the matter of *Refco, Inc., et al.*,[1] involving not only Refco, Inc. but also its unregulated affiliate Refco Capital Markets, Ltd. (RCM), a number of issues were raised after the court initially held that RCM, a Bermuda company, was a "stockbroker" under the Bankruptcy Code.[2] The proceeding raises a host of issues dealing with unregulated derivative dealers and their counterparties. One issue is whether the claims of securities "customers,"[3] as defined under the Bankruptcy Code,[4] would have a priority position over the claims of foreign currency (FX) and derivatives customers. Although the court ruled on the "stockbroker" issue, it postponed the effective date of its ruling to permit parties to attempt to work out a Chapter 11 plan. It appears that the court was searching for a Chapter 11 solution to avoid the unfairness of the priority to securities "customers" over other customers dealing in FX and other financial products. After many months, a Chapter 11 plan was worked out. Although it has not yet been approved by the court, it is likely that the court will approve the Chapter 11 plan. If the Chapter 11 plan is not approved, RCM would be mandatorily liquidated under the "stockbroker" provisions of the Bankruptcy Code.[5]

Although the decision of the Bankruptcy Court may not become final, it highlights the issue of whether and when an unregulated entity would be "stockbroker" under the Bankruptcy Code. Unregulated entities that act solely as a principal and operate offshore with United States institutional customers or unregulated entities operating in the United States that engage in certain activities offshore, including United States government securities activities, repos and similar securities activities, may, in the event of a bankruptcy filing, be considered a "stockbroker" for purposes of the Bankruptcy Code. In such case, securities "customers" would have priority over other customers engaged in FX, derivative or other non-securities transactions. RCM had dealt with institutions as principal in the FX and derivative markets and as principal with other financial products. The fact that sophisticated institutions were the sole counterparties and all transactions were structured as "principal transactions" did not save RCM from being characterized as a "stockbroker" due to its riskless principal securities transactions, prime brokerage activities and other activities involving non-United States securities, primarily emerging country debt securities (ECD).

THE RULING

The judge's initial ruling was oral from the bench and covers approximately fifty pages of transcript.[6] Counsel should study this ruling. Institutions dealing as principal counterparty with an unregistered entity involving FX or derivative transactions may be subordinated in bankruptcy to the priority of any person that is deemed to be a securities "customer." Furthermore, the judge appears to have taken the position that depositing securities for custody, safekeeping, or as collateral pursuant to a collateral security agreement in connection with FX or derivatives transactions may be engaging in securities "customer" transactions. The judge's opinion, since it was oral, at times is not as clear as a more formal, written opinion might be. However, the judge recites significant factual findings from the hearing, which findings affected the ultimate conclusion that RCM was a "stockbroker" with securities "customers" under the Bankruptcy Code.

The Bankruptcy Code defines the term "stockbroker" as follows:

> The term "stockbroker" means person –
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> (A) with respect to which there is a customer, as defined in section 741 of this title; and
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> (B) that is engaged in the business of effecting transactions in securities –
>
> (i) for the account of others; or
>
> (ii) with members of the general public, from or for such person's own account.[7]

Under the Bankruptcy Code, a "stockbroker" is defined in terms of a "customer" as defined in § 741(2) of the Bankruptcy Code[8] and requires that the entity be engaged in the business of effecting securities transactions, either as an agent or with "members of the general public" as principal. The preliminary test is whether the firm has "customers."[9] The judge also found that RCM was engaged in the business of effecting transactions in securities "for the account of others" and therefore was a "stockbroker."[10] The judge also discussed subsection (B)(ii) quoted above and held that he was not ruling whether RCM dealt as principal "with members of the general public"—since RCM dealt with "customers" as agent, it was a "stockbroker."[11] However, the judge in dictum seemed to state that sophisticated financial institutions would be included within the term "general public" because he saw no reason to exclude them, as explained below.[12]

Although the judge was compelled to follow the statutory language of the Bankruptcy Code, the judge's decision on its face appears to create a great unfairness to entities that dealt with RCM in connection with derivatives, FX, and in other transactions that would not qualify them as priority securities "customers". This raises significant issues for any counterparty dealing with an unregulated entity of a financial service firm. Unregulated entities engage in a variety of activities onshore and offshore, including transactions in derivatives, commodities, forwards, repos and other instruments. Some counterparties may qualify as priority securities "customers" and others may not, as explained below.

THE COURT'S FACTUAL FINDINGS RE RCM

The court's initial factual findings and conclusions are important to understanding the ruling. RCM was found to be a Bermuda entity not registered as a broker-dealer with the Securities Exchange Commission (SEC) or otherwise regulated in the United States. Part of RCM's business activity was handled from within the United States.[13] The court found that RCM engaged in FX, derivative, ECD,[14] and "prime brokerage".[15] The issues with respect to prime brokerage and ECD were hotly contested. The court also found that RCM dealt with persons and entities as principal, purchasing and selling ECD and other securities on a regular basis,[16] and that a substantial part of RCM's revenue was from its securities business.[17]

SECURITIES CUSTOMERS

The definition of "customer" in § 741 of the Bankruptcy Code[18] provides as follows:

> (2) "customer" includes –
>
> (A) entity with whom a person deals as principal or agent and that has a claim against such person on account of a security received, acquired, or held by such person in the ordinary course of such person's business as a stockbroker, from or for the securities account or accounts of such entity –
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> (i) for safekeeping;
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> (ii) with a view to sale;
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> (iii) to cover a consummated sale;
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> (iv) pursuant to a purchase;
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> (v) as collateral under a security agreement; or
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> (vi) for the purpose of effecting registration of transfer; and
>
> (B) entity that has a claim against a person arising out of –
>
> (i) a sale or conversion of a security received, acquired, or held as specified in subparagraph (A) of this paragraph; or
>
> (ii) a deposit of cash, a security, or other property with such person for the purpose of purchasing or selling a security;

The definition requires that a customer be an entity that has a claim from dealing with a person as "principal or agent" on account of a securities received, acquired or held by such person in the ordinary course of such person's business as a stockbroker. The statute also requires that the customer claim arise "from or for the securities account or accounts of such entity" (i) for safekeeping, (ii) with a view to sale, (iii) to cover a sale, (iv) pursuant to a purchase, (v) as collateral under a security agreement, or (vi) for purposes of registering transfer. The court found that the "and" at the end of (A)(vi) quoted above was to be construed as an "or", but in any event it appears that most entities that qualify under subsection (A) would also qualify if both subsections (A) and (B) were conjunctive.[19]

The court, in examining the definition of "customer," found that "entrustment" of a security to a broker or dealer was a key to determining a securities "customer,"[20] and the court further implied that cash deposited in an account for the purposes of purchasing securities or that cash from proceeds of securities would also constitute an "entrustment." The court rejected the argument that there was no "entrustment" to RCM because cash or securities deposited could be pledged, hypothecated, or transferred by RCM and the securities were never segregated. It was also argued that if an entity dealt as principal, it could not have entrusted its securities to RCM because RCM acting as principal could do whatever it wanted with the cash or securities.[21] The court also rejected the argument that a customer relationship would arise only if there was a fiduciary relationship.[22]

Although the customer agreement stated that entities dealing with RCM would be acting only as principal-to-principal, the court pointed to other language in the standard customer agreement which stated that the RCM would follow the "instructions" of the customer. The court characterized that language as typical of an agency relationship. The court quoted the customer agreement as follows under the title "Authority to Act":

> You hereby authorize Refco to purchase, sell, borrow, lend, pledge or otherwise transfer financial instruments, including any interest therein, for your account in accordance with oral or written instructions.[23]

The court relied on testimony in the hearing that RCM routinely accepted customers' orders, looked for the best price subject to an agreed upon mark-up or commission, and then executed transactions.[24] The court seems to impliedly characterize riskless principal transactions as agency transactions where the order was given by the customer and there was an agreed upon mark-up or commission in relationship to the price that RCM bought or sold to a third party.[25] The court also noted that account statements showed customer transactions and showed ownership of securities.[26]

The court reviewed various factors that the SEC staff suggested show agency as follows:

> A person effects transactions for the account of others if he or she participates in securities transactions at key points in the chain of distribution.... Factors indicating that a person is engaged in the business include, among others, receiving transaction-related compensation, holding oneself out as a broker, executing trades or assisting others in completing securities transactions, and participating in the securities business with some degree of regularity.[27]

In finding that RCM engaged in prime brokerage, the judge pointed to a foreign entity called IFS, that had approximately 300 offshore customers and cleared through

RCM transactions involving equities, United States treasuries, and ECD. The prime brokerage agreement, according to the court, was between IFS and RCM. The initial opinion is a bit unclear, but it appears that the registered employees of the Miami office of Refco Securities LLC (RSL), a registered broker-dealer, handled most of the activity in connection with the IFS prime brokerage arrangement at its Miami office. The court did not distinguish clearly between the activities of RCM and RSL in Miami. The court also stated that RCM had delivered to IFS a listing of securities held in the IFS account and identified 53 different securities received or held from or for the account of IFS for safekeeping, sale, and purchase.[28] The court then stated that IFS was a customer of RCM for purposes of the customer definition because RCM held securities for safekeeping, sale, purchase, or "as collateral."[29] In summary, the court found that RCM acted as agent for securities customers from time to time.

"WITH THE GENERAL PUBLIC"

Since the court found that RCM engaged in activities as an agent, it stated that it did not need to deal with the words "with the general public" in connection with principal transactions and subsection (B)(2) of § 101(53A). However, the court turned to that subsection and rejected several lower court decisions stating that public customers for purposes of the Securities Investors Protection Act (SIPA)[30] or for other purposes must be non-expert, passive, relatively uninformed investors who trade with the organized exchanges. The court refuted this by referring to SIPA where all customers, informed or uninformed, including institutions, will be protected by priority as a matter of Congressional policy.

CONCLUSIONS

Unregulated entities, and end user counterparties dealing with them, should be particularly aware of the statutory language in Subchapter III of the Bankruptcy Code even though the court's decision has not become final and will likely be vacated if the Chapter 11 plan is approved. The statutory language, as interpreted by the court, raises issues that need to be addressed by counsel for entities dealing with unregulated entities. Likewise, counsel for unregulated entities need to understand the issues raised in the opinion.

In this case the court was somewhat constrained by an out-of-date statute which in today's world appears to create great unfairness to any entity that is not a securities "customer." There is no policy reason why one institution that dealt as a counterparty to RCM in a FX transaction or a derivative transaction should be subordinated to the interest of another institutional entity that effected securities transactions in ECD or other securities or deposited securities as collateral.

It appears that the court was taking the position that custody of securities pursuant to a collateral security agreement may well make an unregulated entity a "securities broker." A customer relationship may also be created if securities are deposited for safekeeping, for sale, to cover a sale, for purchase, as collateral under a security agreement, or for registration. These are all traditional activities which may be done in connection with collateral security agreements. In many cases, cash is deposited to purchase United States treasuries which are held as collateral and those securities are sold when the collateral security agreement is terminated. These collateral security agreements are not unusual in FX and derivative transactions with unregulated entities. If securities deposited pursuant to a collateral security agreement make an unregulated entity a "stockbroker," does a deposit of securities pursuant to a collateral security agreement transform a FX or derivative customer into a securities customer? Under the court's decision and the statutory language, that is a definite possibility. It is possible that some FX or derivative customers would qualify as securities customers under particular circumstances, but not all will qualify—creating further statutory imposed unfairness. This transformation certainly creates a strange situation where the stronger credit counterparty with no collateral security agreement is subordinated to the claim of a weaker credit counterparty that is required to deposit securities collateral.

The court characterized riskless principal transactions at the order of a customer to constitute agency transactions under the facts presented at the hearing. Whether under different facts that same position would be reached by another court remains to be seen. The wording in the customer agreement and the testimony of employees appear to have been determinative in the court's ruling. The court also construed "members of the general public" in subsection (B) of the definition of "stockbroker" to include sophisticated institutions consistent with SIPA treatment. Counsel for unregulated entities should carefully review execution procedures and counterparty agreements in view of the issues raised by the court. A statement in a counterparty agreement that the parties are acting as principal may not prevent a transaction from being re-characterized as an agency transaction.

The policy issue which arises because of the seemingly unfairness of the statute is whether, under the circumstances of today's financial service markets, customers trading one type of financial product, such as FX, or as a counterparty to derivatives, should be subordinated to securities "customers." The unfairness may be lessened because of the broad definition of securities "customer" which may permit certain FX, derivatives, and other similar customers to qualify as securities "customers" under certain circumstances. The court acted pragmatically to avoid this unfairness by withholding the finality of the decision for a period of time to allow the parties to work out a Chapter 11 plan.

Ultimately, Congress should resolve the issues raised by the court by coordinating the Bankruptcy Code "stockbroker" liquidation provisions applicable to certain unregulated entities with those provisions applicable to registered broker-dealers under the Securities Investors Protection Act and the commodity broker liquidation provisions of the Bankruptcy Code. There should be a coordinated and fair distribution of assets held for all customers dealing in financial instruments whether the parties are parties to derivative, FX, futures, or securities transactions.

Notes

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1 Case Number 05-60006 (RDD).
2 11 U.S.C.A. § 101(53A).
3 11 U.S.C.A. § 741(2).
4 11 U.S.C.A. § 747 and 752.
5 11 U.S.C.A. § 741 et seq.
6 For the purposes of this article, citations will be to the transcript of the judge's ruling since there is only an oral opinion.
7 77 U.S.C.A. §101(53A) (emphasis added).
8 11 U.S.C.A. §741(2).
9 See definition of securities "customer" below.
10 Transcript, p. 271.
11 Transcript, p. 271.
12 Transcript, pp. 275-277.
13 Transcript, p. 252.
14 Transcript, pp. 262; p. 266.
15 Transcript, p. 266.
16 Transcript, p. 268.
17 Transcript, p. 272.
18 11 U.S.C.A. § 741(2) (emphasis added).
19 Transcript, p. 240.
20 Transcript, p. 245.
21 Transcript, pp. 256-257.
22 Transcript, pp. 248-249.
23 Transcript, pp. 249-250.
24 Transcript, pp. 257 and 260.
25 Transcript, p. 264.
26 Transcript, p. 269.
27 Transcript, p. 259.
28 Transcript, pp. 266-271.
29 Transcript, p. 267.
30 15 U.S.C.A. §§ 78aaa, et seq.

Sword, Shield [Continued from Page 1]

that there was no exception to patentable subject matter for "business methods," contrary to what had been understood for decades, stating that "[w]e take this opportunity to lay this ill-conceived exception to rest."[4] The court also used the case as an opportunity to clarify that an invention involving mathematical algorithms (which the Supreme Court had ruled was not patentable because it was a mere "abstract idea") may be patentable where it transforms data into a practical application that produces a "useful, concrete and tangible result."[5]

The Federal Circuit's *State St.* decision, coupled with the dramatic increase in electronic trading, spawned a rapid and exponential growth in the number of applications filed for patents in financial services industries, and quickly led to the emergence of litigation over such patents, including in the futures industry. The first such case was based on a patent granted to Susan Wagner, former executive director at the Commission.[6] She applied for a patent on an electronic exchange in 1983, obtaining the patent seven years later (United States Patent No. 4,903,201) and instituting suit against the Chicago Mercantile Exchange (CME), Chicago Board of Trade (CBOT), New York Mercantile Exchange, and eSpeed in 1999. In perhaps the best example of turning a sword into a shield, eSpeed bought the patent for $2-3 million in settlement of the claims against it, and then prosecuted the case as plaintiff against the remaining defendants. The suit was ultimately settled several years later, after much litigation and only days before trial. CME and CBOT each agreed to pay $15 million, and it is reported that royalties paid to eSpeed on that patent (including those paid by Intercontinental Exchange) have been approximately $50 million.

The next wave of patent litigation in the futures industry—perhaps more of a ripple given its short duration—was a lawsuit brought by a Howard Garber, in June 2004, against CME, CBOT, Chicago Board Options Exchange, and OneChicago. Mr. Garber asserted his patent on a method for trading having a principal market maker computer (United States Patent No. 5,963,923); the case was dismissed within six months.[7]

Capturing the most attention of all is the ongoing litigation involving Trading Technologies' patents for "Click Based Trading With Intuitive Grid Display of Market Depth" (United States Patent Nos. 6,766,304 and 6,772,132), which are presently being litigated against eSpeed, Rosenthal Collins, GL, FuturePath, CQG, and Refco in federal court in Chicago. (The lawsuits were all filed separately, but were reassigned to one judge for purposes of resolving common issues.) Trading Technologies (TT) first grabbed the attention of the industry with its "Open Letter to the Futures Industry," issued in December 2004 and "updated" in January 2006, in which TT sought from four exchanges (CBOT, CME, Eurex, and LIFFE) a payment of 2 cents per side—5 cents per trade—in perpetuity and for every futures and futures option transaction on these exchanges.[8] In exchange for these payments, TT offered to not assert against industry participants any of its already-issued patents or the eighty patents that it claims will be issued on pending applications. None of the exchanges has accepted the offer. Perhaps ironically, TT's letter is being used as a basis for the parties in litigation to claim that TT is misusing its patents by seeking to extend their scope beyond the 20-year statutory term and beyond the substantive subject matter they protect. This defense of patent misuse has survived TT's motions to dismiss, although antitrust claims and counterclaims did not.[9]

TT scored an early victory in the litigation when the court found a substantial likelihood that eSpeed's products infringed the patents and that there was not a substantial question that TT's patent were invalid. The court's finding, which was made on denial of TT's preliminary injunction motion (denied for lack of irreparable harm), was on a preliminary record at the beginning of the case and will be superseded by a judgment on the merits on a full record. The early decision is important for the additional reason that the