Futures Industry Association
Law & Compliance Division Workshop
Portfolio Margining Issues
May 11, 2006
Renaissance Harborplace Hotel, Baltimore

BANKRUPTCY JUDGE PRELIMINARILY HOLDS REFCO'S UNREGULATED UNIT TO BE A "STOCKBROKER" FOR PURPOSES OF THE BANKRUPTCY CODE

by:

Paul B. Uhlenhop
LAWRENCE, KAMIN, SAUNDERS & UHLENHOP, L.L.C.
Chicago, Illinois

FUTURES INDUSTRY ASSOCIATION
Law & Compliance Division Workshop
Baltimore, Maryland – May 11, 2006

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LAW & COMPLIANCE DIVISION WORKSHOP

By: Paul B. Uhlenhop, Esq.[1]
Lawrence, Kamin, Saunders & Uhlenhop, L.L.C.
Chicago, Illinois

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INTRODUCTION

In the Chapter 11 proceeding in the matter of *Refco, Inc., et al.*, case number 05-6006 (RDD), involving not only Refco, Inc., but its unregulated affiliate Refco Capital Markets, Ltd. ("RCM"), the Court found after a hearing that RCM, a Bermuda company was a "stockbroker" under the Bankruptcy Code.[2] The result of this would be to give priority to securities "customers"[3] as defined under the Bankruptcy Code[4] and subordinate the claims of foreign currency ("FX") and derivatives customers. Although the Court ruled, it postponed the effective date of its ruling for 45 days 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. If a Chapter 11 plan is not worked out and the ruling becomes final after the 45 days, RCM would be liquidated under the "stockbroker" provisions of the Bankruptcy Code.[5] Under these provisions liquidation is mandatory.

The decision of the Bankruptcy Court, whether it becomes final or not, highlights the issue of whether a number of unregulated entities that act solely as a principal and operate offshore with United States institutional customers through SEC Rule 15a-6 or unregulated entities operating in the United States that engage in certain securities activities onshore or offshore, including United

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[1] PAUL B. UHLENHOP is a member of Lawrence, Kamin, Saunders & Uhlenhop, L.L.C. in Chicago, Illinois. His e-mail address is puhlenhop@lksu.com.
[2] 11 U.S.C. §101[53A].
[3] 11 U.S.C. §741(2).
[4] 11 U.S.C. §747 & 752.
[5] 11 U.S.C. §741 *et seq.*

States government securities, repos and similar securities activities, would, in the event of a liquidation, be considered a "stockbroker." 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 in other areas. The fact that sophisticated institutions were the sole counterparties and all transactions were "principal transactions" did not save RCM from being characterized as a "stockbroker" because of riskless principal securities transactions, prime brokerage and other activities involving non-United States securities, primarily emerging country debt securities ("ECD").

THE RULING

The judge's ruling was oral from the bench and covers approximately fifty pages of transcript.[6] Counsel should study this ruling because it raises a number of questions and issues for unregulated entities and their counterparties that engage as principal in derivative, FX and similar activities particularly if the unregulated entity engages in other activities as agent or principal that may be considered securities activity under the Bankruptcy Code.

Institutions dealing as principal counterparty with an unregistered entity involving FX or derivative transactions may be subordinated in the event of a bankruptcy to the priority of any entity 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 is oral, at times is not as clear as a more formal opinion. 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.

[6] For purposes of this article, citations will be to the transcript of the judge's ruling since there is only an oral opinion.

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

> *The term* "stockbroker" means person –
> (A) with respect to which there is a customer, as defined in section 741 of this title; and
> (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.
> (emphasis added).[7]

Under the Bankruptcy Code, a "stockbroker" is defined in terms of a "customer" as defined in section 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 or not the firm has "customers." *See* definition of securities "customer" below. Although the issue was hotly contested, the judge found that RCM had securities "customers." The judge also found that RCM is engaged in the business of effecting transactions in securities "for the account of others" and therefore was a "stockbroker."[9]

The judge also discussed subsection (B)(2) quoted above and held that he was not ruling whether RCM dealt as principal "with members of the general public" because he found that RCM dealt as agent as explained in more detail below.[10] Since RCM dealt with a "customer" as agent, it was a "stockbroker." 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.[11]

Although the judge had to follow the statutory language of the Bankruptcy Code, the decision on its face appears to create great unfairness to entities that dealt with RCM in connection with derivatives, FX and in other transactions but would not qualify them as securities "customers" who will receive priority. Without priority, the other counterparties may not receive any

[7] 77 U.S.C. §101(53A).
[8] 11 U.S.C. §741(2).
[9] Transcript ("Tr."), p. 271.
[10] Tr., p. 271.
[11] Tr., pp. 275-277.

participation in the bankrupt estate. 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 derivatives, commodities, forwards, repo and other transactions. Some counterparties may be securities "customers" and others may not, as explained below.

THE COURT'S FACTUAL FINDINGS RE RCM

The Court's factual findings and conclusions, however, 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.[12] The Court found that RCM engaged in FX, derivative, ECD[13] and "prime brokerage" as discussed further below.[14]

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.[15] The Court also found that a substantial part of RCM's revenue was from its securities business.[16]

SECURITIES CUSTOMERS

The definition of "customer" in section 741(2)[17] provides as follows:

> "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 –
> (i) for safekeeping;
> (ii) with a view to sale;
> (iii) to cover a consummated sale;

[12] Tr., p. 252.
[13] Tr., pp. 262; p. 266.
[14] Tr., p. 266.
[15] Tr., p. 268.
[16] Tr., p. 272.
[17] 11 U.S.C. §741(2).

(iv) pursuant to a purchase;
(v) as collateral under a security agreement; or
(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 of a "customer" in subsection 741(2) requires that a customer be an entity that has a claim from dealing with a person as "principal or agent" on account of a security received, acquired or held by such person in the ordinary course of such person's business as a stockbroker. The subsection also requires that the customer claim arise "from or for the securities account or accounts of such entity" for:

(i) safekeeping;
(ii) with a view to sale;
(iii) to cover a sale;
(iv) pursuant to a purchase;
(v) collateral under a security agreement; or
(vi) for purposes of registering transfer.

The Court found that the "and" at the end of (A)(vi) 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 subsection (B) was in the conjunctive.[18]

The Court in examining the definition of "customer," found "entrustment" of a security to a broker or dealer was a key to determining a securities "customer."[19] The Court further implies 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.[20] It was also argued that if an entity

[18] Tr., p. 240.
[19] Tr., p. 245.
[20] Tr., _____.

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 agency. The Court quotes 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 customer's 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 had indicated 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

[21] Tr., pp. 256-257.
[22] Tr., pp. 248-249.
[23] Tr., pp. 249-250.
[24] Tr., pp. 257 & 260.
[25] Tr., p. 264.
[26] Tr., p. 269.

> 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 that 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 opinion is a bit murky, but it appears that the registered employees of the Miami office of Refco Securities LLC ("RSL"), a registered broker-dealer did most of the activity in connection with the IFS prime brokerage arrangement at its Miami office. The Court opinion does 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 said 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 as mentioned above it did not need to deal with the words "with the general public" in connection with principal transactions and subsection (B)(2) of section 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 through the organized exchanges. The Court

[27] Tr., p. 259.
[28] Tr., p. 266-271.
[29] Tr., p. 267.
[30] 15 U.S.C. §78aaa, *et seq.*

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.

CONCLUSION

Unfortunately, in this case the Court was somewhat constrained by an out-of-date statute which in today's world creates great unfairness to any entity that is not a securities "customer." There is no 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.

The statutory language, as explained in the ruling, 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. It should be noted the decision may open a narrow window so that some FX and derivative counterparties may be considered securities customers if they deposited securities in connection with a collateral security agreement as discussed below.

It appears that the Court is 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 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 may qualify as securities customers under particular circumstances, but not all will qualify creating further statutory unfairness. If so, the decision may not be quite as unfair as it appears on its face. However, this transformation certainly creates a strange situation where the stronger credit counterparty with no collateral security agreement is subordinated to the claims 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 in the case. 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 constructed "members of the general public" in subsection (B) of the definition of "stockbroker" principal transactions to include sophisticated institutions consistent with the SIPA treatment. Counsel for unregulated entities should carefully review execution procedures and counterparty agreements. 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.

Regardless of whether the ruling becomes final, unregulated entities and counterparties dealing with them should be particularly aware of the statutory language. If the ruling becomes final, it is expected to be appealed and the underlying factual and legal conclusions will be hotly contested. In the event of a subsequent opinion, some of the preliminary conclusions of the Court may well be reversed.

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.

Ultimately, Congress should resolve these issues by more carefully 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 Act. There should be a coordinated and fair distribution of assets held for all customers dealing in financial instruments whether or not the parties are parties to derivative, FX, futures or securities transactions.

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