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MF GLOBAL: A COMPARISON OF THE TRUSTEE'S REPORT RECOMMENDATIONS AND THE HOUSE STAFF'S REPORT RECOMMENDATIONS–

A MUST READ FOR ANYONE INVOLVED WITH THE FINANCIAL RESPONSIBILITY LAWS AND REGULATIONS GOVERNING CFTC-REGULATED FCMs AND SEC-REGULATED BROKER-DEALERS

BY: PAUL B. UHLENHOP, LAWRENCE, KAMIN, SAUNDERS & UHLENHOP, L.L.C.

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I. INTRODUCTION

The MF Global, Inc.[1] ("MFGI") bankruptcy shocked the financial service world and raised a significant number of regulatory and other issues that will shape the future world of financial service regulation, including securities, futures and derivatives. On June 4, 2012, the Trustee in the MFGI liquidation filed a report of the Trustee's investigation and recommendations ("Trustee's Report").[2] On November 15, 2012, the staff of the U.S. House of Representatives Subcommittee on Over-

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We are pleased to note that our Editoral Board member, Geoffrey Aronow, was recently appointed General Counsel of the Securities and Exchange Commission. He will be taking a leave of absence from our Board while he is serving in the public sector.

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From the EDITOR

Welcome to Swapland America, U.S. Person

I like to be in America!
O.K. by me in America!
Everything free in America!
For a small fee in America!
West Side Story, by Stephen Sondheim

On January 7, 2013, the U.S. Commodity Futures Trading Commission ("CFTC") published a Federal Register release entitled "Final Exemptive Order Regarding Compliance with Certain Swap Regulations" (the "Release"). The Release was anything but final. It is a time-limited "final" order exempting certain "non-U.S. Persons" from compliance until July 12, 2013, with many swaps regulations adopted by the CFTC. The "final" order expires on July 13, 2013, at which point a new final order will be applicable. The final order contained in the Release allows a non-U.S. Person to exclude certain swap transactions engaged in either with other non-U.S. Persons or with foreign branches of U.S. swap dealers from their calculations that determine whether such non-U.S. Person must register as a swap dealer or major swap participant ("MSP") with the CFTC as well as providing relief from certain regulatory obligations until July 13, 2013. Nevertheless, if the non-U.S. Person's swaps with U.S. Persons exceed certain thresholds, the non-U.S. Person will still be required to register with the CFTC as a swap dealer or MSP.

Whether a foreign entity is a "U.S. Person" will be determinative of whether the new CFTC swap registration, entity-level and transaction-level requirements apply to such U.S. Person, or to a non-U.S. Person who is a counterparty to a U.S. Person (referred to as a "U.S. facing transaction").

The "final" order in the Release sets forth an interim definition of the term "U.S. Person" (the "Interim Definition") that will expire on July 12, 2013, with a proposed new definition about which the CFTC has requested public comments. The Interim Definition provides that a U.S. Person is:

(i) *Natural Person Prong*-A natural person who is a resident of the United States;

(ii) *Entity Prong* -A corporation, partnership, limited liability company, business or other trust, association, joint-stock company, fund or any form of enterprise similar to any of the foregoing, in each case that is (A) organized or incorporated under the laws of a state or other jurisdiction in the United States or (B) effective as of April 1, 2013, for all such entities other than funds or collective investment vehicles, having its principal place of business in the United States;

(iii) *Pension Plan Prong*-A pension plan for the employees, officers, or principals of a legal entity described in (ii) above, unless the pension plan is primarily for foreign employees of such entity;

(iv) *Estate or Trust Prong*-An estate of a decedent who was a resident of the United States at the time of death, or a trust governed by the laws of a state or other jurisdiction in the United States if a court within the United States is able to exercise primary supervision over the administration of the trust;

(v) *Account Prong*-An individual account or joint account (discretionary or not) where the beneficial owner (or one of the beneficial owners in the case of a joint account) is a person described in (i) through (iv) above; or

(vi) *Foreign Branch Prong*-A foreign branch of a person described in (i) through (v) above.

In the Release, the CFTC also proposed to expand the U.S. Person definition by including in the Prong (ii) any corporate entity, other than a limited liability corporation or limited liability partnership where the partners have limited liability, that is directly or indirectly majority-owned by one or more natural persons or corporate entities that are U.S. Persons if the owners bear ultimate responsibility for the obligations and liabilities of the legal entity. The CFTC further proposed to include in the U.S. Person definition any commodity pool, pooled account, investment fund or other type of collective investment vehicle that is directly or indirectly majority-owned by one or more natural persons or corporate entities that are U.S. Persons, but would exclude publicly traded funds, because the determination of such ownership may be difficult, if such funds were not offered directly or indirectly to U.S. Persons. Importantly, the CFTC has not proposed that a commodity pool that is operated by a person required to register as a commodity pool operator should be considered to be a U.S. Person based solely on such registration requirement. The CFTC has invited public comment on these proposed expansions of the definition.

In *West Side Story*, Maria sang that everything is free in America, except for a small fee. If you are determined by the CFTC to be a U.S. Person or engaged in U.S. facing transactions, your small fee may be registration with the CFTC, membership in the National Futures Association, and compliance with new and complicated CFTC clearing, entity-level and transaction-level requirements, unless you are located in a country that the CFTC may find has equivalent derivatives clearing, reporting, and customer protection requirements to warrant a "substituted compliance" determination by the CFTC. In fairness to the CFTC, the swaps market is global in nature. The CFTC is trying to grapple with the Dodd-Frank requirement that the CFTC extend its jurisdictional reach to activities that occur outside the U.S. if they have a direct and significant connection with activities in, or effect on, commerce in the U.S. However, the CFTC is a U.S. regulator and other countries also are developing sophisticated derivatives regulatory programs. We encourage global swaps participants who do not want to enter America for even the small fee of being required to comply with CFTC regulations to comment to the CFTC on the proposed very broad definition of U.S. Person and to encourage their home country regulators to do the same.

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CONTINUED FROM PAGE 1

sight Investigations Committee on Financial Service released a staff report ("House Report") with respect to MFGI.[3] The recommendations and the conclusions of the two reports ("Reports") have some significant differences that are particularly important with respect to expected legislation, regulation, and business practice changes in the financial service world. This article also discusses the regulatory response, mainly by the Commodity Futures Trading Commission ("CFTC") and the National Futures Association ("NFA") which have proposed, and in the case of the NFA adopted, new regulations significantly enhancing the protection of customer assets held by a futures commission merchant ("FCM"). Although the Reports are lengthy (the Trustee's Report is 181 pages without appendices[4] and the House Report is 97 pages), anyone in the financial service area should be familiar with what happened at MFGI, how it might have been prevented and the regulatory response. At a minimum, one should review the Executive Summary in each report and the conclusions and recommendations.

Part II of this article provides a synopsis of the factual background of material events. Part III sets forth the Reports' conclusions and recommendations. Part IV summarizes the regulatory responses to the Reports. Part V discusses the Reports' recommendations and the regulatory responses.

II. SYNOPSIS OF EVENTS LEADING UP TO THE BANKRUPTCY FILING UNDER CHAPTER 11 OF THE BANKRUPTCY CODE[5]

A. The Insolvency.

On October 31, MF Global Holdings, Ltd. ("Holdings") filed for reorganization under Chapter 11 of the Bankruptcy Code, following which the Securities Investor Protection Corporation ("SIPC") commenced a proceeding to liquidate MFGI together with other MF Global subsidiaries and affiliates referred to as MF Global. At the time of the Trustee's Report, the shortfall in segregated property available for return to customers was approximately $900 million for domestic accounts (both securities and commodities), plus an additional approximately $700 million related to trading by customers on non-U.S. exchanges. Most of the latter part of the shortfall involves property (the 30.7 funds) that was being withheld by the Joint Special Administration of MF Global United Kingdom ("MFGUK").[6] This stunning shortfall in customer property created the MF Global debacle.

B. The Regulators and Customer Asset Protection Rules.

A number of U.S. and foreign regulatory agencies and exchanges regulated MF Global's business. In the United States, MFGI was principally regulated in the futures markets by the CFTC, the CME Group, and the NFA, and in the securities markets, by the Securities and Exchange Commission ("SEC"), the Financial Industry Regulatory Authority ("FINRA"), and the Chicago Board Options Exchange ("CBOE"). The activities of MF Global's foreign affiliates were overseen by foreign regulatory authorities.

The CFTC, SEC and their SROs have minimum net capital rules which require a FCM or BD, as the case may be, to comply at all times with its minimum financial requirements.[7] In the case of a firm that is both a BD and a FCM, the firm is required to compute its minimum net capital under both the SEC scheme and the CFTC scheme and use the highest of the two requirements for its minimum net capital. The purpose of the net capital rules is to provide that only liquid assets are counted for capital purposes. Non-liquid assets are discounted depending on liquidity.

Both the CFTC and the SEC have rules with respect to notification of the SEC, the CFTC, and applicable SROs, exchanges, and clearinghouses of certain events such as falling below capital requirements, failing to deposit appropriate amounts of customer funds and assets required under the segregation provisions of the respective regulatory agency.[8]

The CFTC requires that U.S. customer assets be kept in "customer segregation" or in "secured accounts" if the customer is trading on a non-U.S. market.[9] The assets in the customer segregated account and the customer secured accounts must be maintained at a bank, custodian clearinghouse, other FCM, or other approved depository ("Depository"). The FCM must have a written agreement with the Depository that it recognizes that the customer property is the property of the customer and is not to be used, directly or indirectly, by the FCM or Depository or any other person for their benefit. These agreements, called no-lien letter agreements, must be obtained from each Depository. Many of the provisions of no-lien letter agreements are mandated and are quite complex. Both Reports state that MFGI used funds from both the segregated customer account and the secured customer account intra-day for proprietary purposes in the summer and fall.[10]

The CFTC regulations allow an FCM to contribute property (cash and/or securities) to the customer segregated and secured accounts to overfund the accounts so that if there is a mistake in calculation of the amount of assets to be held in the customer segregated and secured accounts, the accounts will be overfunded and not under funded.

Customer funds and securities that have been entrusted to BDs are regulated under SEC Rule 15c3-3, the SEC customer protection rule.[11] Under the rule, a BD must obtain and maintain physical custody or control (as defined in the rule) of all fully paid and excess margin securities carried for the customers. In addition, the BD must maintain a special account entitled "Special Reserve Account for the Exclusive Benefit of Customers" ("Reserve Account"). Most importantly, a BD must maintain in a Reserve Account a dollar amount not less than the dollar amount computed under the reserve formula of Rule 15c3-3 which is calculated weekly as of the close of the last day of business of the prior week. That calculation generally computes the net money owed to customers. This rule is the SEC equivalent of CFTC Rules with respect to segregation. It should be noted that there are a number of pending changes to SEC Rule 15c3-3, which were proposed by the SEC in 2007 and reproposed in 2012.[12] The rule changes proposed include certain additional customer asset protection provisions.

C. March 2010 to Summer of 2011.

In March 2010, Jon Corzine became Chief Executive Officer and Chairman of the Board of Holdings. Mr. Corzine moved quickly to attempt to transform what had been a long-standing FCM combined with a BD conducting modest customer and proprietary business into a full service global investment bank. After Mr. Corzine arrived, he directed changes in personnel, lines of business and markets. Mr. Corzine shifted the firm focus to a significant amount of proprietary trading, including a proprietary account which he managed.[13]

The focus of the proprietary positioning was European sovereign debt securities. The European sovereign debt trades were structured as "repos to maturity" ("RTM").[14] Sovereign debt was purchased by MFGI at a discounted price and repoed back to its MFGI-affiliate MFGUK. The Trustee's Report explains the rationale of the structure as follows:

> **"Because the termination of RTMs between MFGI and MFGUK was the same date as the maturity of a sovereign bond, accounting rules allowed MF Global to account for the RTM as a sale and therefore record an immediate gain on the sale while removing the transaction from MF Global's consolidated balance sheet. The corresponding repo transaction between MFGUK and CH Clearnet (previously known as the London Clearing House) ("LCH"), however, was for a term of two days shorter than the maturity date of the underlying bonds. This disparity meant that MFGUK—which turned to MFGI to provide funding—would ultimately have to finance the sovereign bonds for a two-day window, thus increasing the amount of cash MFG needed to maintain the RTM portfolio."[15]**

In addition, MFGI continued to bear the risk of default of these bonds.

D. August 2011 to October 17, 2011.

In August of 2011, because of concerns about MF Global's exposure to sovereign debt, FINRA required MFGI to record additional capital charges required under the SEC net capital rule 15c3-1 to reflect liquidity risks associated with the European sovereign portfolio debt. This caused a liquidity issue and resulted in a shortfall of the required minimum net capital under SEC Rule 15c3-1. The shortfall caused a $183 million capital infusion to be made to MFGI to satisfy the need to increase its net capital. The issue of liquidity, which was present became more acute and continued into the fall.[16]

On October 17, a report in the *Wall Street Journal* focused attention on MF Global's infusion of $183 million additional capital required by FINRA and the SEC which had been disclosed on September 1st. After October 17, events rapidly proceeded to the ultimate liquidation.[17] The Trustee's Report states that:

> **On October 24, Moody's Investor Service downgraded MF Global's credit rating to near junk status. Then on October 25 MF Global held its third quarter earnings call during which it announced $119 million write-off of deferred tax assets signaling increased doubt about short-term prospects for profitability in the near term. The next day, S&P put MF Global on "Credit Watch negative and on October 27, Moody cut MF Global to junk status."[18]**

From this point, "a classic run-on-the-bank" began as securities and futures customers began to withdraw securities and cash from their accounts at MFGI. Importantly, counterparties, other depositories and credit providers refused to deal without additional collateral or security.[19] This brought a huge stress to the firm's accounting and control systems because of the number of transactions and the movement of money in and out of MFGI. "On October 26, there was an unprecedented interday transfer of $615 million from the FCM to fund proprietary securities trading in an amount that was not returned to the FCM before the close of business."[20] As of the close of business on October 26, "MFGI was out of regulatory compliance with respect to customers segregated funds and they remained so through October 31."[21] At the same time, MFGI advised customers it was "hold[ing] all customer cash and collateral in CFTC Rule 1.25 and Rule 30.7 Customer Segregation [accounts]…."[22] "On October 28, MF Global personnel made a $175 million transfer from FCM customer funds to MFGUK to clear an overdraft at JP Morgan ("JPM")."[23]

The Trustee's Report described the events of October 31 as follows:

> **Before a transfer was made on the morning of October 31—when certain funds that had been locked up for securities customers pursuant to SEC Rule 15c3-3 were transferred to the FCM—the shortfall resulting from transfers from the FCM amounted to approximately $900 million. Contrary to some public reports, the shortfall of customer property at MFGI was not caused by direct investment of customer funds in sovereign debt. Rather, as detailed below, the actions of management and other employees, along with lack of sufficient monitoring and systems, resulted in FCM customer property being used during the liquidity crisis to fund the extraordinary liquidity drains elsewhere in the business, including margin calls on the European sovereign debt positions.[24]**

III. THE CONCLUSIONS AND RECOMMENDATIONS

A. The Trustee's Conclusions and Recommendations

1. Abolish the alternative calculation method and implement a required excess cushion for customer funds.
2. Eliminate the segregated vs. secured distinction currently made by [CFTC] Regulation 30.7, ensure consistency of customer protection when trading overseas, and closely monitor compliance abroad.
3. Create a protection fund for futures and commodities customers under a certain threshold, and implement suitability standards for FCM customers.

4. Provide for civil liability for officers and directors in the event of commodities segregation shortfall.
5. Simplify CFTC Rules for bulk transfers and claims in an FCM liquidation proceeding.
6. Enact legislation explicitly authorizing Trustee standing on behalf of customers.

B. The House Staff Conclusions and Recommendations

1. Jon Corzine caused MF Global's bankruptcy and put customer funds at risk.
2. The SEC and the CFTC failed to share critical information about MF Global with one another, leaving each regulator with an incomplete understanding of the Company's financial health.
3. MF Global was not forthright with regulators or the public about the degree of exposure to its European bond portfolio nor was the Company forthright about its liquidity conditions.
4. Moody's and S&P failed to identify the biggest risk to ML Global's health until very late in the game.
5. MF Global's use of the "alternative method" allowed the Company to use some customer funds as a source of capital for the Company's day-to-day operations, which subjected customers to the risk that MF Global would not be able to return those funds to customer accounts upon the Company's insolvency.
6. The New York Fed should have exercised greater caution in determining whether to designate MF Global as a primary dealer, given the Company's prior risk management failures, chronic net losses, and evolving business strategy.
7. Differences between foreign and U.S. law gave rise to the potential that MFGI global customers trading on foreign exchanges would experience a "shortfall" in funds owed to them, despite the fact that such funds were set aside in accounts designated as secured accounts.
8. The Committee on Agriculture should consider whether to direct the CFTC to study whether it can better mitigate the risks that FCM customers face when customer funds are placed in secured accounts subject to the law of a foreign jurisdiction. In conducting any such study, the CFTC should consider whether the rules that govern trading on foreign exchanges should be amended to establish protections comparable to those that govern domestic transactions. In particular, the CFTC should consider whether any potential rule change could impose costs on FCMs and their customers that would place foreign futures and options trading at a competitive disadvantage to similar products and services.

IV. THE REGULATORY RESPONSE TO THE MF GLOBAL DEBACLE

A. The Futures Industry, CFTC, NFA, and CME Responses.

Shortly after the bankruptcy of MFGI, the futures industry, the CFTC, the NFA, and the clearinghouses for futures and derivatives moved quickly to address a number of issues subsequently raised in the Trustee's Report and in the House Report even though those investigations and Reports were not yet published. The urgency of revised customer asset protection was further emphasized by the insolvency of the firm Peregrine Financial Group, Inc., which had a shortfall of customer funds of over $200 million.[25]

On July 13, 2012, the CFTC approved changes to the NFA Financial Requirements Section 16 proposed by the NFA together with an accompanying related interpretive notice entitled "NFA Financial Requirements Section 16" effective September 1, 2012.[26]

On November 14, the CFTC published for comment proposed changes of its rules in Parts 1, 3, 22, et al., entitled "Enhancing Protections Afforded Customers and Customer Funds Held by

Future Commission Merchants and Derivatives Clearing Organizations Rules."[27] The CFTC's proposed rules follow closely the NFA's Section 16 referenced above. The CFTC succinctly summarized the new NFA Rule as follows:

> **NFA's Segregated Funds Provisions require each FCM to:**
>
> (1) Maintain written policies and procedures governing the deposit of the FCM's proprietary funds (i.e., excess or residual funds) in customer segregated accounts and Part 30 secured accounts;
>
> (2) maintain a targeted amount of excess funds in segregate accounts and Part 30 secured accounts;
>
> (3) file on a daily basis the FCM's segregation and Part 30 secured amount computations with NFA;
>
> (4) obtain the approval of senior management prior to a withdrawal that is not for the benefit of customers, whenever the withdrawal equals 25% or more of the excess segregated or Part 30 secured amount funds;
>
> (5) file a notice with NFA of any withdrawal that is not for the benefit of customers, whenever the withdrawal equals 25% or more of the excess segregated or Part 30 secured amount funds;
>
> (6) file detailed information regarding the depositories holding customer funds and the investments made with customer funds as of the 15th day (or the next business day if the 15th is not a business day) and (the last business day of each month); and
>
> (7) file additional monthly net capital and leverage information with NFA.
>
> **Significantly, NFA's Segregated Funds Provisions also require FCMs to compute their Part 30 secured amount requirement and computer their targeted excess Part 30 secured funds using the same Net Liquidating Equity Method that is required by the Act and Commissions regulations for computing the segregation requirements for customers trading on U.S. contract markets under section 4d of the Act. FCMs are not permitted under the NFA rules to use the Alternative Method to compute the Part 30 secured amount requirement. The failure of an FCM to maintain its targeted amount of excess Part 30 funds computed using the Net Liquidating Equity Method may result in NFA initiating a Membership Responsibility Action ("MRA") against the firm.**
>
> **In addition, in setting the target amount of excess funds, the FCM's management must perform a due diligence inquiry and consider various factors relating, as applicable, to the nature of the FCM's business, including the type and general creditworthiness of the FCM's customers, the trading activity of the customers, the types and volatility of the markets and products traded by the FCM's customers, and the FCM's own liquidity and capital needs. The FCM's Board of Directors (or similar governing body), CEO or Chief Financial Officer ("CFO") must approve in writing the FCM's targeted residual amount, any changes thereto, and any material changes in the FCM's written policies and procedures. (Emphasis added.)**
>
> **The NFA Board of Directors also approved on August 16, 2012, amendments to NFA financial requirements for FCMs that will require each FCM to provide its DSRO with view-only access via the Internet to account information for each of the FCM's customer segregated funds account(s) maintained and held at a bank or trust company. The same requirement would apply to the FCM's customer secured account(s) held for customers trading on foreign futures exchanges.**
>
> **In addition, the NFA rule amendments provide that if a bank or trust company is unable to allow the FCM to provide its DSRO with view-only full access via the Internet, the bank or trust company will**

> **not be deemed an acceptable depository to hold customer segregated and secured accounts. NFA intends to expand its oversight of FCMs under the amended rules, once the amendments are implemented, to receive daily reports from all depositories for customer segregated and secured accounts, including FCMs that are clearing members of DCOs. NFA plans to develop a program to compare the balances reported by the depositories with the balances reported by the FCMs in their daily segregation reports. An immediate alert would be generated for any material discrepancies.[28]**

The NFA published on November 21, 2012 further details on implementation of Section 16 as follows:

> *FCM daily confirmation system*
>
> **Earlier this year, as part of NFA's ongoing effort to further safeguard customer funds, NFA's Board approved a proposal to develop a daily segregation confirmation system that would require all depositories holding customer segregated and secured amount funds—including banks, clearing FCMs, broker-dealers and money market accounts—to file daily reports reflecting the funds held in segregated and secured amount accounts with each FCM's designated self-regulatory organization (DSRO). The DSRO would then perform an automated comparison of that information with the daily segregation and secured amount reports filed by the FCMs to identify any material discrepancies.**
>
> **In November, NFA's Board approved amendments to Financial Requirements Section 4 in order to implement this new daily confirmation system. The new amendments will require an FCM to instruct its depositories holding segregated, secured amount and cleared swaps customer collateral to report those balances to a third party designated by NFA. The amended rule also states that in order for a depository to be deemed acceptable, it must report the FCM's customer segregated and secured amount balances and cleared swaps customer collateral balances to a third party designated by the NFA. (Emphasis added.)**
>
> **The daily confirmation system is still under implementation, but the first phase, beginning with banks, is expected to be implemented by December 31. Other categories of depositories will be added in 2013.[29]**

B. Securities Regulators

On the securities side, there has not been as much activity in response to the collapse of MFGI or the two Reports as there was in the futures and derivatives industry possibly because MFGI's securities business was comparatively small in relationship to its futures and derivatives activities. As a result, the impact on customers was less because SEC Rule 15c3-3 provisions for a reserve account and control of customer securities were apparently in large part followed and there was not the huge shortfall that was involved in the futures and derivatives side of the business. As a consequence, the recommendations and conclusions of the two Reports only indirectly impact SEC Rule 15c3-3. Furthermore, as noted above, the SEC has had pending since 2007 a significant number of modifications to SEC Rule 15c3-3, some of which increase customer asset protection.[30]

Neither Report made recommendations about SEC Rule 15c3-3 and its underlying scheme of customer asset protection. However, SEC Rule 15c3-3 has a key problem because its reserve fund amount may lag actual customer assets held by the BD under certain circumstances by more than a week creating a potential shortfall of protected customer assets. For most firms subject to Rule 15c3-3 (holding customer funds or securities), the reserve account calculation is based upon the amount determined on Monday based upon the close of business on the prior Friday. The amount determined is required to be deposited Tuesday morning. As a result, when the Reserve fund deposit is being made on Tuesday, the reserve fund calculation lags actual customer assets by one day and continues not to reflect actual customer assets until the time for the next reserve deposit, leaving a gap of almost a full week for a shortfall in customer funds to occur. If the BD has a net inflow of customer funds and securities, the reserve account fund would be significantly underfunded for as many as six business days, putting customer assets at risk. The SEC and the industry have struggled over the years to resolve this problem and evolve to next day settlement like the futures industry, but the discussions have not yet been fruitful because of a variety of reasons, including the complexity and costs of solutions.

V. DISCUSSION OF CONCLUSIONS AND RECOMMENDATIONS

A. Trustee's Recommendations

1. Abolish the alternative calculation method and implement a required excess cushion for customer funds.

a. The Alternative Method.

The Trustee recommends and the House staff also recommended (5th recommendation) that the alternative calculation method used for calculating the amount of secured funds for U.S. customers trading on non-U.S. exchanges should be abolished and the secured funds of such customers calculated in essentially the same manner as segregated funds.[31]

In the MFGI bankruptcy, there was a significant shortfall in the secured funds account for U.S. customers trading on foreign exchanges. Part of this shortfall was caused by the secured account computation using the alternative method which did not match the monies actually owed to customers trading on foreign exchanges.[32] As discussed above, the NFA has adopted regulations in effect eliminating the alternative computation method and the CFTC has proposed regulations which would eliminate the alternative method.[33] For all practical purposes, the recommendations by both the Trustee and the House staff have been adopted and the alternative may not be used.

b. The Excess Cushion

The recommendation of a proprietary excess cushion of funds has been implemented by NFA Financial Requirements Section 16 which requires each FCM to have written policies and procedures with respect to the segregation accounts and the secured accounts including maintaining a residual interest amount in the accounts. Section 16(a) of the NFA Financial Requirements requires that the written policies and procedures among other things must target amounts either by percentage or by dollars of proprietary assets that the FCM must maintain as a residual interest in both customer segregated accounts and customer secured accounts to reasonably "ensure" that the FCM is maintaining an amount of segregated and secured customer assets above the amount of required segregated customer and secured customer assets in order to payout customers in the event of insolvency. The residual amount must also be in excess of margin deficit. The FCM's board of directors, chief executive officer, or chief financial officer must approve in writing the FCM's targeted residual interest amount, any change in it, and any material changes in the FCM's written policies and procedures regarding the maintenance of the FCM residual interest. Any change in them must be reported to the CFTC and NFA.[34]

Importantly, Section 16 of the NFA rules provides for daily reports to the NFA and CFTC with respect to the required amounts in segregation and secured accounts, including the residual interest amount. In addition, there is a comprehensive no lien agreement required of banks and other Depository holding customer segregated or secured assets in custody. The no lien agreement must provide, among other things, that the assets are property of the customer, not the FCM and will be turned over promptly in a liquidation proceeding. Furthermore, the Depository must acknowledge in the no lien agreement that the CFTC or NFA or an authorized third party may access electronically the bank or other Depository records with respect to the customer segregated account and secured accounts at that Depository. The agreements are lengthy with many other terms designed to provide customer protection.

The CFTC, as explained above, has proposed rules paralleling those of the NFA.[35] The NFA Section 16 rules now in effect and the CFTC proposals (when approved) will significantly improve customer asset protection but will not eliminate all risk. Moreover, Section 16 and the corresponding CFTC rules will be expensive to install and operate. Some members have criticized the requirement that the residual interest must be in excess of margin deficit, if any. Nevertheless, the industry appears to generally support the changes because they provide credibility to the public regarding customer asset protection which had been undermined by the debacle of MFGI and the subsequent collapse of Peregrine.

2. Eliminate the segregated vs. secured distinction currently made by [CFTC] Regulation 30.7, ensure consistency of customer protection when trading overseas, and closely monitor compliance abroad.[36]

a. Merging Secured and Segregation Accounts.

The second recommendation of the Trustee's Report and of the House Report is to eliminate the segregation versus secured distinction currently made by Section 4d of the CEA[37] and CFTC Regulation 30.7.[38] The second recommendation of the Trustee also provides that there should be consistent customer asset protection when U.S. customers trade overseas or on U.S. exchanges.

Although elimination of the secured account has been a goal of futures regulators and the futures industry for many years, sovereign countries have their own legal systems for insolvent financial entities which do not always favor customers as does the U.S. Bankruptcy Code. In approving the NFA's Financial Requirement Section 16, and in the CFTC proposed rules with respect to customer protection, the CFTC has elected to keep the difference between funds for U.S. customers trading on U.S. exchanges and secured funds for U.S. customers trading on foreign exchanges. As demonstrated in MF Global, it is important to continue to maintain the distinction because of the differing risks taken by U.S. customers that trade on foreign exchanges. Among the risks is the insolvency law risk, but there are also numerous other risks that are involved in trading on foreign exchanges by U.S. customers. U.S. customers that trade on U.S. exchanges should not be exposed to these foreign risks and for that reason, maintenance of a division of separate schemes for customers trading on U.S. exchanges and those trading on foreign exchanges will be maintained under the new NRA rules and the proposed CFTC rules.

b. Monitoring Foreign Insolvency Law.

The last part of the Trustee's second recommendation is to closely monitor foreign insolvency's impact on U.S. customers trading on non-U.S. markets. The CFTC has tried to monitor the insolvency laws of the principal financial centers, but this is a difficult and almost impossible task. Notwithstanding the attempts at convergence of financial regulation throughout the world, in a number of countries the impact of a financial firm insolvency is unclear and subject to change.

At the time of the MFGI bankruptcy, MFGUK held significant customer assets and property of MFGI. MFGUK is being liquidated under the laws of England and Wales (England), by a Joint Special Administrator ("JSA"). The JSA contested the following claims of the MFGI Trustee:

> **i. The MFGI 30.7 Client Asset Claim of approximately $640 million in property that the Trustee believed was or should have been secured for former MFGI 30.7 Customers.**
>
> **ii. The MFGI Client Money Claim of approximately $270 million, which was comprised of approximately $95 million in respect of MFGI's open positions held with MFGUK as of October 31, 2011. The MFGI Client**

> **Money Claim also includes the $175 million wire transfer from MFGI to MFGUK on October 28, 2011.**
>
> **iii. Unsecured creditor claims of approximately $465 million relating to collateral posted with respect to RTM transactions, intercompany repurchase transactions, and other miscellaneous items.[39]**

This dispute was recently settled subject to court approval.[40] The settlement did not result in return of all U.S. customer assets claimed by the Trustee.

It is important to disclose to U.S. customers trading on foreign exchanges through U.S. FCMs and BDs that their money is subject to an insolvency law different than the U.S. insolvency law and under certain circumstances the U.S. customers' assets may not have priority, may not be repatriated to the United States or may be subject to other unknown and uncertain risks. For this reason, it is important for the CFTC and SEC, as well as the individual FCMs to be mindful of these risks and disclose to their customers where appropriate the principal perceived risks and that there may be other unknown or uncertain risks.

3. Create a protection fund for futures and commodities customers under a certain threshold, and implement suitability standards for FCM customers.[41]

a. Insurance Fund.

For a number of years, the idea of a SIPC[42]-like insurance fund for the futures industry has been studied at length and the conclusion, sometimes contested, has been that a SIPC-like entity is not needed in the futures and derivatives industry because of the clearinghouses, segregation and also the nature of the product. Nevertheless, MFGI raises questions and issues which should be carefully reviewed in view of the revised customer asset protection, convergence of markets, the expectation of U.S. customers, and the successes and failures of SIPA and SIPC.

b. Suitability.

Although the futures industry does not have specific suitability standards, it does have significant FCM disclosure requirements when a customer opens an account and thereafter. The disclosures appear on the FCM's website, in account documents, and elsewhere, explaining that futures and futures options trading is not for everyone and gives specific reasons why. The futures industry and its customers generally are of the view that anyone should be allowed to trade futures and options on futures as a hedger or speculator as long as the possible material risks are disclosed, which is done usually by a disclosure to customers. For those reasons, it is unlikely that suitability requirements will be adopted.

4. Provide for civil liability for officers and directors in the event of commodities segregation shortfall.

The fourth recommendation of the Trustee is to provide for civil liability for officers and directors in the event of a segregation or secured account shortfall.[43] In view of the current securities and futures laws which provide significant regulatory sanctions, civil liabilities, and criminal penalties, civil liability would not appear to be a significant additional deterrent.

Furthermore, a shortfall in customer segregated assets may be totally unintentional and caused by bona fide lack of information or the complexity of the segregation calculation or 15c3-3 reserve calculation. MF Global itself is a good example particularly during the last two to three weeks of its existence because there was so much confusion and extraordinary transactions which in many cases were outside the control of any one person. Furthermore, many of the personnel at MF Global were acting with only partial knowledge because of the stress on its systems and personnel. In almost all cases, employees who acted had nothing personally to gain from the activities. When a firm is having credit issues and market credibility issues, the number of transactions and stress on the treasury and accounting functions become hectic and disorganized because of the volume, the number of customers attempting to withdraw funds, the increasing demands for security by counterparties, creating as it did in MF Global a series of substantial errors ranging in the amount of hundreds of millions of dollars which are difficult to unwind and reconcile as was seen in MF Global. It is very easy to understand how the person who is doing the computing may not know of specific transactions, as in the MF Global case, or whether a transaction was a deposit or a withdrawal because the responsibility is in another department or with another person.[44]

In summary, it is unlikely that additional civil liability for officers and directors will ensure that there will be no segregation shortfall because no matter what the best efforts of the officers are, the firm may very well have a segregation shortfall.

5. Simplify CFTC Rules for bulk transfers and claims in an FCM liquidation proceeding.[45]

a. Bulk transfers.

In the event of a liquidation of a FCM or BD, if the trustee is able to transfer all or significantly all of the customers' assets and their positions at an insolvent FCM or BD to a solvent FCM or BD that accepts the accounts, it assists the customers immeasurably by allowing them to immediately effect transactions or continue their financial activities as if there had been no insolvency. However, bulk transfers depend upon the insolvent firm having good books and records so the customer positions, assets and liabilities can be determined account by account. Furthermore, the insolvent BD or FCM must be holding the positions and assets for the customers as shown by its records. If the positions and margin are at the clearinghouse, they should be transferrable with the stroke of a pen to another FCM.

On the securities side, a bulk transfer may or may not be somewhat easier. If there are minor asset shortages for customer accounts, SIPC may from time-to-time guarantee all of the customer assets to the receiving BD to facilitate a bulk transfer. Although both CFTC and SIPC have attempted to improve bulk transfer procedures, there remains a lot to be done. However, what the regulators and Trustee can do is limited by the conditions discussed above.

b. Claims[46]

The claims process in MF Global was a nightmare for many small futures traders and hedgers such as ranchers, farmers, jewelers, and a whole range of small commodity customers. Thanks to the futures industry, many FCMs set up assistance desks to assist MF Global customers in completing the very complicated claims form. The futures industry, with the CFTC and the clearinghouses should be and are working together to simplify the claims forms to make them readily understandable and easy to use. However, the complexity of futures and securities transactions requires complex claim forms that may be used for complex transactions. The CFTC and futures industry should develop different claims forms for customers who are not engaged in complex trading strategies.

6. Enact legislation explicitly authorizing Trustee standing on behalf of customers.[47]

The last recommendation of the Trustee is a request for legislation to provide the bankruptcy trustees in financial service firm bankruptcies standing to represent the customer claimants against third parties. MF Global customers sued third parties such as MF Global officers and affiliates. The Trustee also sued the same third parties. In MF Global, the customers' counsel and the Trustee developed a working agreement to cooperate. Recently, the Trustee and customers reached a settlement agreement with the third parties which is subject to court approval.[48] Under the settlement, the Trustee withdrew and let the plaintiffs continue to litigate the claims. However, the MF Global bankruptcy estate would receive a percentage of the recoveries, if any, from the third party defendant.

In some cases it may be more efficient for the trustee to control litigation against third parties. If the Trustee could combine all litigation into one case pending in one district, it should be much more efficient because it would save on pretrial motions, pretrial discovery, and more importantly avoid inconsistent results and jurisdictional fights.

It is not expected that Congress will act on the Trustee's recommendation to enact legislation exclusively authorizing the Trustee standing on behalf of the customers, but on its face the recommendation appears to have merit.

B. The House Committee Staff Findings and Recommendations

1. Jon Corzine caused MF Global's bankruptcy and put customer funds at risk.[49]

As discussed previously, the first finding of the House Report is that "Jon Corzine caused the MF Global bankruptcy and put customer funds at risk."[50] The causation conclusion reflects on a number of detailed facts set forth in the House Report, primarily focusing on the large accumulation of foreign sovereign debt RTM securities and the failure to realize the vulnerability of the firm under certain scenarios. In addition, Mr. Corzine is faulted for the various risks and transfers of customer funds during the last week of MF Global's operation.

2. The SEC and the CFTC failed to share critical information about MF Global with one another, leaving each regulator with an incomplete understanding of the Company's financial health.[51]

Although the House Report criticizes the SEC and CFTC, it appears that both Reports also show that the SEC, CFTC, and SRO staffs did share a significant amount of critical information with one another under difficult conditions. Moreover, the SEC and CFTC may not have appreciated the speed with which liquidity would dry up from all sources at MFGI, when the press, market, and counterparties started to focus on the possible illiquidity of the European sovereign debt RTM exposure and other negative information. The staffs of both the SEC and CFTC are highly sophisticated, well aware of the law, hard working, and do usually share critical material information in similar situations.

Over the years the amount of information shared between the two regulators has increased but it has also ebbed and flowed, depending mostly on the personalities of the Chairpersons, the Commissioners and the staffs of the two regulators. Furthermore, had the SEC and CFTC shared more information and focused on MF Global, Inc. at an earlier date when the bonds were being purchased, it is by no means certain that the SEC and CFTC would have been able to forestall the MF Global collapse. The SEC or CFTC's authority to second guess proprietary trading decisions is controlled in large part by net capital rules which provide haircuts for positions that have liquidity issues. When the extent of the European sovereign debt RTM purchases and the possible illiquidity was discovered in late summer 2011, the SEC, FINRA and the CFTC promptly required additional capital by way of increases to net capital. But until the last part of the fatal week, the SEC and/or CFTC could not force MFGI to liquidate because it did not appear to be a violation of the capital rules. Only when the credit dried up during the last five days was there a crisis and both the SEC and CFTC had teams on site. That does not mean that staff on site knew what was going on and specifically about some of the transfers in and out of customer asset segregation and SEC reserve account Rule 15c3-3. The SEC, CFTC, FINRA, CME, and the NFA were demanding information but not getting answers because the MFGI employees due to the confusion didn't have answers.[52] It certainly appears from both Reports that even had the MFGI staff understood the full extremity of the situation, it would have been impossible for them to reconcile quickly all of the errors and differences that were caused by the significant number of transactions, mostly by customers liquidating positions and moving funds out of MFGI and the freezing of its credit at various counterparties.

3. MF Global was not forthright with regulators or the public about the degree of exposure to its European bond portfolio nor was the Company forthright about its liquidity conditions.[53]

The House Report concluded that MF Global was not forthright with the regulators or the public about the European bond portfolio or the firm's liquidity condition. The European sovereign debt securities were certainly a complicating factor and the single largest constraint on the liquidity of MF Global during its last week and during the several weeks before that. However, the European bond portfolio was not the only factor. There were additional material contributing factors, including but not limited to, the withdrawal by many customers of their funds, liquidation of their positions at MF Global, and the decision of futures and securities clearinghouses, banks, and other financial institutions to refuse to deal without higher margin or collateral.

4. Moody's and S&P failed to identify the biggest risk to ML Global's health until very late in the game. [54]

The House Report faults Moody's and S&P particularly because they did not specifically warn the public that MFGI had escalating exposure to the underlying sovereign debt RTMs and that mark-to-market movements associated with it which could cause volatility in MF Global's financial results. The House staff states that there was information available for five months regarding European sovereign debt RTM exposure and that Moody's and S&P did not factor in such exposure to its public credit assessments until later in October. The House Report states that the failures of Moody's and S&P are "notable because they suggest an absence of due diligence."[55] The House Committee's perceived failures by Moody's and S&P may have some merit but the conclusion should be tempered somewhat because of the circumstances from which the illiquidity accelerated and the subsequent lack of credit to continue its business.

The House Report also criticizes S&P and Moody's for faulty ratings in other instances and states that the failures of the rating agencies to exercise due diligence have significantly affected markets and investors. The House Report suggests additional unspecified legislation or rules with respect to credit rating institutions. Congress may revisit the rating agency regulation, but it is not expected to do so in the immediate future nor is it expected that the SEC will take action or change its regulatory posture vis-à-vis the rating agencies. Moody's and S&P are reviewing and may revise some of their procedures.

5. MF Global's use of the "alternative method" allowed the Company to use some customer funds as a source of capital for the Company's day-to-day operations, which subjected customers to the risk that MF Global would not be able to return those funds to customer accounts upon the Company's insolvency.[56]

The fifth point of the House recommendations deals with the alternative method which was previously discussed. *See* Section V.A.1.a.

6. The New York Fed should have exercised greater caution in determining whether to designate MF Global as a primary dealer, given the Company's prior risk management failures, chronic net losses, and evolving business strategy.[57]

This relatively strong statement is followed by suggestions dealing with the New York Federal Reserve Bank ("NY Fed") procedures and policies with respect to designating primary dealers. The House Report recommended that the NY Fed examine its procedures and application guidelines to expressly forbid companies from speaking about their application status unless required for regulatory disclosure purposes.[58] In addition, the subcommittee urged the NY Fed to re-examine its primary dealer selection process to provide for greater scrutiny. The NY Fed has commenced a review and is in the process of changing its procedures with respect to designating primary dealers.

7. Differences between foreign and U.S. law gave rise to the potential that MFGI global customers trading on foreign exchanges would experience a "shortfall" in funds owed to them, despite the fact that such funds were set aside in accounts designated as secured accounts.[59]

The seventh recommendation of the House Report dealing with foreign bankruptcy law and customers trading on foreign exchanges has been discussed previously under the Trustee's Report recommendation. *See* Section V.A.2.a and b.

8. The Committee on Agriculture should consider whether to direct the CFTC to study whether it can better mitigate the risks that FCM customers face when customer funds are placed in secured accounts subject to the law of a foreign jurisdiction. In conducting any such study, the CFTC should consider whether the rules that govern trading on foreign exchanges should be amended to establish protections comparable to those that govern domestic transactions. In particular, the CFTC should consider whether any potential rule change could impose costs on FCMs and their customers that would place foreign futures and options trading at a competitive disadvantage to similar products and services.[60]

This is essentially the same recommendation discussed above and is discussed under the Trustee's Report recommendation nos. 1 and 2 at Section V.2.a and b.

VI. CONCLUSION

The MF Global debacle brought to light a number of problems with customer asset protection in the futures and securities world. The futures industry and the CFTC, CME, and NFA and other futures regulators have developed and are implementing significant new robust customer protection based on the NFA's Financial Requirements Section 16 and the proposed CFTC rules to monitor customer assets at FCMs and other approved Depositories on a regular basis in relationship to the reported customer segregated or secured requirements.

Although the distinction between U.S. customers trading on U.S. exchanges and U.S. customers trading on non-U.S. exchanges remains, the industry and the regulators should emphasize in appropriate disclosures the enhanced risks that a customer has trading offshore.

The CFTC should review the need, if any, of a SIPA-like insurance fund in view of the regulatory changes.

It is unlikely that civil liability for FCM personnel would deter potential violators in view of the present law which provides a range of criminal, civil or regulatory sanctions and penalties if there is intentional diversion of customer assets. The SEC, CFTC, and the respective self-regulatory organizations should continue to expand their information sharing concerning customer asset protection and financial responsibility.

It is unlikely that the House Report's comments on MF Global disclosures and Moody's and S&P's downgrade timing will result in additional laws or regulations.

The House Report's remarks regarding the New York Federal Reserve Bank have resulted in its changing prime dealer selection processes and further changes are expected.

Customer asset protection is the key to the financial service firms' credibility to its customers. The CFTC, NFA rules changes discussed above have made it much more difficult for the occurrence of a shortfall of customer assets if a FCM or BD becomes insolvent. Even with excellent supervisory procedures diligently carried out, certain fraudulent schemes can continue for a number of years; for example, the Madoff scheme and many others. The malefactors in many cases are absolutely brilliant, work very hard to facilitate their scheme and may do so for a period of time without being detected. Notwithstanding the laudable recent rule changes to customer asset protection, the rules to be effective require management, compliance, auditors and regulators to have a healthy suspicion of irregularities and aggressively investigate the irregularities.

NOTES

[1] For purposes of this article, MF Global is used sometimes in the Reports and in this article to include MFGI, its parent and affiliates. Although there were various inter-affiliate transactions of importance, they will be noted by separate reference.

[2] *In re MF Global, Inc., Debtor*, Case No. 11-2790 (MG SIPA).

[3] Although there is a five and a half month interval between the two reports, the interval does not materially affect the substantive facts or legal conclusions.

[4] The Trustee has also filed "Trustee's Second Six Month Interim Report for the Period June 5, 2012 Through December 4, 2012" which Report details the administration of the bankruptcy estate.

[5] This synopsis is designed to provide a modicum of background for the reader. The Executive Summary in each report provides additional detail.

[6] Trustee's Report, p. 15.

[7] SEC Rule 15c3-1, 17 CFR 240.15c3-1; CFTC Rule 1.17, 17 CFR 1.17; net capital rules are very complicated and details are beyond the scope of this article.

[8] CFTC Rule 1.14, 17 CFR 1.14; SEC Rule 17a-11, 17 CFR 240.17a-11.

[9] Section 4d of the Commodity Futures Act (§ 7 USC 6(d)) accounts hold the property of customers trading on domestic exchanges and under CFTC Rule 30.7 (17 CFR 30.7) the foreign secured accounts hold customer property of customers trading on foreign exchanges.

[10] Trustee's Report, p. 12.

[11] SEC Rule 15c3-3; 17 CFR 240.15c3-3.

[12] Amendments to Financial Responsibility Rules for Broker Dealers, Release No. 34-55431 (March 8, 2007); Reproposed Release No. 34-66910 (May 3, 2012).

[13] Trustee's Report, pp. 5-6.

[14] Trustee's Report, p. 7.

[15] *Id.*

[16] Trustee's Report, p. 8.

[17] Trustee's Report, p. 13.

[18] *Id.*

[19] Trustee's Report, p. 14.

[20] *Id.*

[21] Trustee's Report, p. 15.

[22] *Id*; CFTC Rule 1.25 implements the statutory segregation section 4d of the CFA, 7 USC § 6(d).

[23] *Id.*

[24] *Id.*

[25] *In re Peregrine Financial Group, Inc.*, Case No. 12-27458 (N.D. Ill. 7/10/2012).

[26] NFA Manual Financial Requirement Section 16; SEC Notice-to-Members 1-12-15 (Aug. 24, 2012); NFA Notice-to-Members 1-12-23 (Oct. 1, 2012).

[27] 77 FR 67866 (Nov. 14, 2012).

[28] 77 FR 67865-67971 (Nov. 14, 2012).

[29] http://www.nfa.futures.org/news/member-newsletter-2012/121912.HTML

[30] Amendments to Financial responsibility Rules for Broker Dealers, Release No. 34-66910 (May 3, 2012); originally proposed March 2007, Release No. 34-55431; 72 FR 12862.

[31] Trustee's Report, p. 171; House Report, p. 90.

[32] The other part of the problem was that a substantial amount of the assets of U.S. customers trading on foreign exchanges was held by affiliates offshore which have not been repatriated. *See* Section V.A.2 regarding the issues and recommendations with respect to U.S. customers trading abroad and some special risks that the funds entail because of different insolvency and bankruptcy laws of foreign jurisdictions.

[33] NFA Financial Requirements Section 16 effective September 1, 2012.

[34] NFA Manual Financial Requirements Section (a).

[35] 77 FR 67866 (Nov. 14, 2012).

[36] Trustee's Report, p. 172; House Report, p. 95.

[37] 7 USC § 6(d).

[38] 17 CFR 30.7.

[39] "Motion of Trustee to Approve Settlement Agreement Between Debtor, the Trustee MF Global UK Limited (in Special Administration) and MFGUK Joint Special Administrator." *In re MF Global, Inc.*, Case No. 11-2790 (MG) SIPA (U.S. Bankruptcy Court S.D. N.Y.), p. 7.

[40] *Id.*

[41] Trustee's Report, p. 172.

[42] The Securities Investor Protection Act (SIPA), 15 USC § 78aaa *et seq.*

[43] Trustee's Report, p. 176.

[44] In fact, when risk and surveillance procedures are prepared, many firms, as a check, divide responsibilities for funds being withdrawn or entering the firm from those who are doing the computation. Division of responsibilities provides a check against fraud.

[45] Trustee's Report, p. 176.

[46] Trustee's Report, p. 177.

[47] *Id.*

[48] *Supra,* FN 39.

[49] House Report, p. 76.

[50] *Id.*

[51] House Report, p. 79.

[52] The SEC and CFTC could serve document requests or request testimony but all of that takes time, far more time than could possibly be devoted to obtaining the information by such means rather than by obtaining it directly from the staff of MF Global whose systems were strained or not functioning during the last week which prevented the MFGI staff from realizing the full extremity of the status of customer funds in segregation, secured or the 15c3-3 reserve account.

[53] House Report, p. 83.

[54] House Report, p. 87.

[55] House Report, p. 88.

[56] House Report, p. 90.

[57] House Report, p. 92.

[58] House Report, p. 94.

[59] House Report, p. 95.

[60] House Report, p. 96.

Trading Places: "Swaps" Morph Into "Futures" Via a CFTC 4d Order

ROBERT ZWIRB*

In October 2012, the CFTC approved a request by a prominent clearinghouse to allow both U.S. and non-U.S. energy futures to be held in the same segregated customer account.[1] In particular, the CFTC order permits the clearinghouse and its members to hold funds deposited to margin energy futures contracts that are cleared by that organization in a CEA Section 4d(a) account, the segregated customer account that historically has been limited to domestic futures and options.[2] In addition to allowing domestic and foreign futures to be held in a single account, the CFTC's order allows the clearinghouse to offer portfolio margining and margin offsets for such positions, thus effectively reducing the margin requirements for its customers.

These regulatory actions—the request by the clearinghouse and the approval of that request by CFTC—raise a number of important policy questions. For example, why is the clearinghouse here seeking to mix what are legally apples with oranges in the same account, *i.e.,* the funds of customers trading in futures cleared in the U.S. with those cleared abroad? Moreover, was it necessary to go to the trouble to seek regulatory permission to commingle U.S. and non-U.S. futures in 4d(a) account? After all, funds deposited by U.S. customers for foreign futures and options transactions already are afforded protection under CFTC Rule 30.7, which requires that property from foreign futures and foreign options customers be maintained in a separate account in what is known as a foreign futures or foreign options secured amount account.

Finally, and perhaps most significantly, is this action really about combining in one account "futures" that are cleared in different jurisdictions—or is something larger going on?

Background

Under the Commodity Exchange Act ("CEA"), funds deposited by a customer with a futures commission merchant ("FCM") to secure futures, options, and certain swaps contracts must be maintained in a "segregated" account for the exclusive benefit of the depositing customer.[3] This does not mean that each customer has his own separately segregated account—indeed, customer property posted as collateral is segregated on an "omnibus" or pooled basis—it means only that funds of customers must be kept separate from funds of the FCM.

The segregation requirements provide important safeguards for futures customers. For example, they prohibit an FCM from using one customer's funds to margin another customer's positions. If one customer fails to post sufficient margin, the FCM is required to deposit its own funds into the customer-segregated omnibus account in order to protect the FCM's other customers against the default of that failing customer. In the event an FCM becomes insolvent, customers are given a priority in bankruptcy as to their segregated funds.

Beyond segregating customer funds from FCM funds, the CFTC bankruptcy rules also require the segregation of certain types of customer funds from other types. That is, the CFTC rules require the maintenance of separate pools or account classes of customer property (including separate pools for U.S. futures, foreign futures, and cleared swap accounts). The pools are distinguished in part by the degree to which such property is kept in segregation.[4] This approach reflects the fact that segregation requirements for some account classes are more stringent than for others.[5] Segregation by account type therefore means that customers whose funds are subject to the full stringency of segregation under CEA Section 4d(a) do not have to share their property in any potential liquidation of an FCM with customers whose property is subject to a more lenient form of segregation, such as, for example, funds subject to the less stringent Rule 30.7 foreign futures secured-amount requirement.[6]

Historically, the protections provided by the CEA's segregation requirements applied only to domestic exchange-traded contracts, *i.e.,* futures and commodity options traded on U.S. exchanges. Beginning in 2004, however, the CFTC extended these protections via orders issued pursuant to CEA Section 4d(a) ("Section 4d Orders") first to foreign futures and options, and then several years later, to "cleared-only contracts," *i.e.*, contracts that although not executed or traded on a Designated Contract Market ("DCM") are subsequently submitted for clearing through an FCM to a Derivatives Clearing Organization ("DCO").[7] Then in 2010, the CFTC amended its bankruptcy rules to create a new and completely separate account class for positions in "cleared OTC derivatives." These new rules gave futures-like protection to many cleared swaps, even without a Section 4d Order.[8] However, while domestic futures could be combined with foreign futures or cleared OTC swaps in a 4d(a) segregated account, the reverse was not true: futures could not be combined with cleared swaps in a cleared OTC account.[9]

The enactment of Dodd-Frank modified this general framework by requiring "cleared swaps" customer collateral be segregated in accordance with a new statutory provision (CEA Section 4d(f)) expressly for the segregation of cleared swaps.[10] Under this new framework, DCOs and clearing member FCMs may now commingle customer positions in futures and cleared swaps either in i) a Section 4d(a) futures account pursuant to a Section 4d Order issued by the Commission, *or* ii) a Section 4d(f) cleared swaps account pursuant to DCO rules approved by the Commission under CFTC Rule 40.5.[11]

So, today, the benefits of segregation have been extended to holders of foreign futures and cleared swaps. Moreover, today there are also three account types where futures and swaps collateral may be combined in somewhat different regimes: 1) the futures or Section 4d(a) account class, 2) the cleared swap or Section 4d(f) account class, and 3) the foreign futures or Rule 30.7 account class.[12]

Analysis

Before we can determine whether permitting U.S. and non-U.S. futures to be held in the same account is a positive or negative development for customers, we must first resolve what it is really going on, in particular:

(i) whether this is about combining U.S. futures with foreign futures, or

(ii) whether it is about combining swaps and futures.

While the petition states that it is about combining "energy futures with energy contracts that are foreign futures,"[13] it also notes and that "[t]hese products have previously been cleared . . . on an OTC basis."[14] This latter statement strongly suggests that the real purpose of the petition is to commingle "swaps," in particular the clearinghouse's energy swaps, with "futures" in the same segregated 4d(a) account, so that the swaps can be regulated as futures and not as swaps under Dodd-Frank.

How do "foreign futures" enter the picture? In addition to customer transactions involving foreign futures and options, the CFTC allows "non-regulated transactions" to be included in the CFTC Part 30.7 secured amount account for swaps not subject to a 4d order.[15] OTC derivatives cleared by clearing organizations such as LCH.Clearnet for U.S. customers have long been held in 30.7 accounts intended for *foreign futures and options*. That was because prior to 2010, there was no other place to park them that provided the benefits of segregation or equivalent protection other than in a 4d account, and the CFTC, as noted above, had already given its blessing to such an unusual arrangement. Although, another avenue opened up in 2010 for protecting the funds of OTC customers with the CFTC's designation of a new account class specifically for "cleared OTC derivatives" under CFTC Rule 190.01(a),[16] placing customer funds in this account class required the relevant clearinghouse to issue a rule or by-law for that purpose. By contrast, placing cleared OTC customer collateral in a 30.7 secured account avoided the legal costs and uncertainty associated with either of these two avenues, since there was no need for the clearinghouse to issue a rule or petition the Commission for a 4d order.

Moreover, whether due to inertia or otherwise, 30.7 remained the parking place for many cleared OTC derivatives even after the CFTC created a new account class for such transactions. Customers of Lehman Brothers and MF Global, however, discovered to their surprise that their positions in cleared OTC derivatives were held in 30.7 accounts and therefore subject to foreign rather than U.S. law when those firms failed, even where such positions were handled by U.S. FCMs and originated on U.S. exchanges such as the Nodal Exchange. More importantly, such distinctions have significant real world effects, for in the case of MF Global, while the Trustee in that insolvency proceeding to date has been able to return 93 cents on the dollar for 4d property, he has been able to return only five cents on the dollar for 30.7 property.[17]

The CFTC's approval of this petition to transfer of cleared swaps from a § 30.7 account to a 4d account, however, raises two questions. The first pertains to the legality of the move, *i.e.*, is it legally sound? Apparently so, since the CFTC says it is legally sound, although the petition candidly observes that CFTC Rule 39.15(b)(2), which establishes standards and procedures for the submission of a petition for an order under which futures, options, and swap positions may be held in the futures account subject to the requirements of CEA Sec. 4d(a) of the Act "does not specifically address commingling of foreign futures as opposed to swaps."[18]

The second question relates to the merits of such a move. Why not instead move these energy swaps to the new account class created by Dodd-Frank specifically for cleared swaps? That is, why does the clearinghouse here want to park them in a futures account rather than the new account class established for "cleared swaps" under CEA Section 4d(f)? Although the 4d(a) segregated futures account has always been considered the Cadillac of all account classes in terms of providing customer protection (at least until the advent of LSOC), the principal motivation here appears to involve the clearinghouse's desire to avoid subjecting these transactions to the Dodd-Frank regulatory regime for swaps. Recall last summer, the clearinghouse involved here announced that it would begin a process of converting its energy "swaps" into "futures."[19] This petition is about carrying out the move. As the petition candidly acknowledges, this is about "transition[ing] certain of its cleared . . . OTC energy swap products to energy futures and options contracts."[20]

So the immediate effect of this action is to allow the clearinghouse to commingle its swaps with futures in a 4d segregated account. Is that good? It depends in part on where you are located on the clearing food chain. Recall that the CFTC's issuance of an interpretative statement in 2008 to treat "cleared OTC derivatives" as "commodity contracts," followed by its promulgation of a rule in 2010 to create a separate "account class" for such positions for bankruptcy purposes, initially raised concerns that i) the CFTC's view regarding the legal status of cleared OTC derivatives lacked legal authority and more importantly,[21] ii) that inflows of such derivatives into 4d accounts could threaten the integrity of those customer segregated accounts meant for futures and raise risks of default for clearing organizations and their customers.[22]

While the legal issue was rendered moot by Dodd-Frank's treatment of cleared swaps as "commodity contracts," the policy issue, by contrast, has never really been settled. In particular, commenters in 2009 to a similar petition by the CME to commingle customer funds used to margin credit default swaps with other funds held in segregated accounts expressed grave concerns that such commingling could delay or even prevent the transfer of exchange-traded futures positions to a solvent FCM.[23] While those concerns would ultimately not find acceptance by the CFTC,[24] that action did not quell the fundamental concerns resulting from mixing oranges and apples in the same account. Even the CFTC post-Dodd-Frank has implicitly acknowledged these concerns.[25] These continuing concerns illustrate the tensions that are sure to develop as OTC derivatives are swept into a legal framework that was originally intended to protect customers of insolvent *futures* commission merchants.

Conclusion

Obviously the portfolio margining benefits associated with combining swaps and futures in one account is a big positive for customers since margining such positions separately results in significant additional costs and inefficiencies. But even the clearinghouse here concedes that it "currently offers margin offsets between such products in the Rule 30.7 account class."[26]

As with any regulatory move of this nature, trade-offs are involved. While customers who invest in both futures and swaps will benefit, those that hold only futures may not like having their segregated benefits diluted by the presence of OTC newcomers. Conversely, those newcomers may have something to fear from having their funds commingled into futures accounts that do not have the benefit of new "LSOC" regime for swaps customers. But those trade-offs appear to be beside the point, for again what this action is really about is to allow the clearinghouse to morph its swaps into futures in order to avoid the more onerous regulatory burdens of Dodd-Frank applicable to swaps, and the CFTC to some surprise is going along. [27]

Thus, while Dodd-Frank may have cleared a path for cleared swaps customers to receive better protection in bankruptcy, the very onerous swaps regime is causing clearing organizations to close down that path. That is, the clearing organizations have seemingly decided that customers are better off sacrificing the bankruptcy protections afforded by the new regulatory regime if the customers can thereby avoid the regulatory burdens created by the new regime. So how much benefit is there to the new regime? As mentioned, there should be considerable benefit to customers from both a portfolio management perspective and from being able to avoid Dodd-Frank. But from a bankruptcy standpoint, it may not be that much, and arguably may be a detriment to existing futures customers.

NOTES

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1. CFTC Order, *Treatment of Funds Held in Connection with Clearing by ICE Clear Europe Limited of Contracts Traded on ICE Futures Europe and ICE Futures US* (Oct. 9, 2012).

2. More specifically, the order allows ICE Clear Europe and its clearing members to commingle customer property used for margining contacts traded on ICE Futures Europe, and cleared through ICE Clear Europe, to be commingled with futures that are traded on ICE Futures US and cleared through ICE Clear Europe in what is known as a "Section 4d(a) account," the segregated account usually reserved for domestic futures and options under Section 4d(a) of the CEA.

3. CEA Section 4d.

4. *See* CFTC Rule 190.01(a)(1).

5. 46 Fed. Reg. 57535, 57554 (Nov. 24, 1981) (noting that "much of the benefit of segregation would be lost if property segregated on behalf of a particular account class could be used to pay the claims of customers of a different account for which less stringent segregation provisions were in effect").

6. See 69 Fed. Reg. 69510, 69511 (Nov. 30, 2004) (Interpretative Statement).

7. See 69 Fed. Reg. 69510 (Nov. 30, 2004) (interpretative statement permitting funds supporting foreign futures to be deposited in a futures account and segregated in accordance with CEA Section 4d) and 73 Fed. Reg. 65514 (Nov. 4, 2008) (interpretative statement clarifying that property margining "cleared-only contracts," i.e., contracts not executed on a DCM, but submitted for clearing through an FCM to a DCO, may be included in a futures account and segregated in accordance with CEA Section 4d).

8. See 75 Fed. Reg. 17297, 17301 (Apr. 6, 2010) (treating OTC derivatives that a customer clears through an FCM with DCO-cleared OTC derivatives as commodity contracts). The new account class was made applicable only to the bankruptcy of a commodity broker that is an FCM.

9. See 77 Fed. Reg. 6336, 6360 (Feb. 7, 2012) (noting that "while section 4d(a)(2) of the CEA permitted the inclusion in the domestic futures account class of transactions and related collateral from outside that class, there was no similar provision permitting the inclusion in the cleared OTC account class of transactions and related collateral from outside that latter class").

10. In response to this new authority, the CFTC amended its definition of "account class" in Part 190 of its rules, reducing it from six classes to five and renaming the one pertaining to "cleared OTC derivatives" to "cleared swaps." As a result, today the types of customer accounts that must be recognized as separate classes of account by a trustee in bankruptcy are: futures accounts, foreign futures accounts, leverage accounts, delivery accounts, and cleared swaps accounts. CFTC Rule 190.01(a)(1).

11. See CFTC Rule 39.15(b)(2). At the same time, the CFTC adopted for cleared swaps only a new model of segregation called the "legally segregated operationally commingled model" or "LSOC" that provides enhanced protections for the collateral associated with such swaps in the event of an FCM insolvency than that provided under the traditional futures model. See Protection of Cleared Swaps Customer Contracts and Collateral; Conforming Amendments to the Commodity Broker Bankruptcy Provisions, 77 Fed. Reg. 6336, 6349 (Feb. 7, 2012) (Final Rule).

12. The CFTC in October 2012 proposed prohibiting FCMs from holding any positions in a Part 30 secured amount account other than customers' foreign futures and option positions and associated margin collateral. See CFTC Notice of Proposed Rulemaking, Enhancing Protections Afforded Customers and Customer Funds Held by Futures Commission Merchants and Derivatives Clearing Organizations, at 128-129 (Oct. 23, 2012).

13. Letter from Paul Swann, President & Chief Operating Officer, ICE Clear Europe, ICE Clear Europe, to CFTC, Petition for an Order Pursuant to Section 4d(a) of the Commodity Exchange Act to Permit Commingling of Customer Funds in Connection with Energy Futures and Foreign Futures Contracts, at 1 (Aug. 6, 2012) ("ICE Clear Europe Petition").

14. *Id.* at 5.

15. See CFTC Advisory 87-4 (Nov. 18, 1987) and CME Advisory Notice AIB 08-05 (Oct. 10, 2008).

16. See 75 Fed. Reg. 17297 (Apr. 6, 2010).

17. Trustee's Ninth Interim Status Report on Claims, Inre MFGlobal, Debtor, Bankruptcy Case No. 11-2790 (MG) SIPA, Case No. 12-CV-6014, at 7 (Bankr. S.D.N.Y., Feb. 4, 2013).

18. ICE Clear Europe Petition at 4.

[19] See ICE Press Release: IntercontinentalExchange to Transition Cleared Energy Swaps to Futures in October (Sep. 4, 2012).

[20] ICE Clear Europe Petition at 2.

[21] See 77 Fed. Reg. at 6360 (noting that when the CFTC in 2010 established a new account class for cleared OTC derivatives, "there were questions concerning the Commission's authority to require the segregation of cleared OTC derivatives (and related collateral) or to establish a separate account class for cleared OTC derivatives in a DCO insolvency.").

[22] In particular, commenters to a petition by the CME to commingle customer funds used to margin credit default swaps with other funds held in segregated accounts, expressed concerns that such commingling could delay or even prevent the transfer of exchange-traded futures positions to a solvent FCM. See Revised Petition by CME, CME Submission # 08-175R (Dec. 21, 2009.

[23] See e.g., Comment Letters by FIA and MF Global, Inc. & Newedge, USA LLC (Feb. 4, 2010) (questioning "the fundamental fairness . . . of requiring futures customers to cross-guarantee CDS contracts").

[24] See 75 Fed. Reg. at 17298-99.

[25] See 76 Fed. Reg. 69392 (Nov. 8, 2011) (observing that swaps "will expose DCOs to risks that can differ in their nature and magnitude").

[26] ICE Clear Europe Petition at 2.

[27] See Craig Pirrong, *A Swap By Any Other Name*, Streetwise Professor (Aug. 2, 2012) ("ICE has merely relabeled its cleared energy swaps as futures in order to avoid burdening its customers with the costs that [Dodd-Frank] imposes on swaps.").

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