Client Alert

Latham & Watkins Corporate Department

Account Transfer in the Event of an FCM Liquidation

This *Client Alert* addresses the impact on a customer of a futures commission merchant (FCM) with respect to his or her accounts held by that FCM prior to a filing for bankruptcy under Title 11 of the United States Code, 11 U.S.C. §§ 101-1532 (the Bankruptcy Code) by the FCM.

> "[I]f an FCM fails to comply with these regulations and either does not segregate funds at all or uses customer funds for other purposes, a customer's ability to transfer accounts will be limited by the availability of funds in the customer accounts."

Summary

Prior to the date when an FCM files for bankruptcy, there are generally few restrictions on customers' ability to transfer their accounts to another FCM. This continues to be the case even after an FCM's parent files for bankruptcy. FCM customers have historically been able to transfer their futures accounts as an FCM's bankruptcy approached with relative ease because certain regulations impose strict responsibilities on FCMs to segregate and protect customer funds. As a result, an FCM's segregated account should always have enough collateral to cover redemption requests from all of its futures customers. Practically speaking, however, if an FCM fails to comply with these regulations and either does not segregate funds at all or uses customer funds for other purposes, a customer's ability to transfer accounts will be limited by the availability of funds in the customer accounts.

Analysis

Generally, FCM customers have wide latitude to transfer or withdraw "commodity accounts" prior to an FCM's bankruptcy. A "commodity account" is the segregated book-entry account maintained by the FCM that contains a commodity customer's commodity contract,[1] and a "commodity contract" is, with respect to an FCM, a "contract for the purchase or sale of a commodity for future delivery on, or subject to the rules of, a contract market or board of trade."[2] Therefore, FCM customers generally may transfer or withdraw their futures accounts held by or for an FCM on their behalf at any time before a bankruptcy filing.

Upon a bankruptcy filing by an FCM under Chapter 7 of the Bankruptcy Code or under the Securities Investor Protection Act of 1970 (SIPA),[3] a trustee will be appointed to (i) liquidate the assets of the failed FCM and (ii) return Customer Property[4] to customers as soon as possible.[5] Importantly, Customer Property is not considered the property of the insolvent FCM estate and therefore is not subject to the claims of creditors of the FCM.[6] Customer Property is supposed to be distributed as quickly as possible to Customers. There are generally three types of claims that a customer of a failed FCM can have in a liquidation, and distributions on account

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of these claims will be made according to a certain priority. Under Sections 766(c) and (h) of the Bankruptcy Code (and similar provisions of SIPA), the trustee will first distribute to all customers "any specifically identifiable security, property, or commodity contract to which such customer is entitled."[7] This type of property is generally referred to as "customer name property," and any customer with customer name property is entitled to the return of the actual property and not simply the cash value of that property.

Second, the trustee will then distribute "net equity claims" of customers. "Net Equity Claims" are defined generally as the claim that a customer has against the estate based on the commodity contracts held by the debtor for such customer, less any indebtedness of the customer to the debtor.[8] All Net Equity Claims are valued as of the date on which the liquidation is commenced (*i.e.*, without regard to any subsequent movement in the market price of the assets in question) and paid on a pro rata basis from all customer property held by the FCM upon the conversion of any non-cash assets into cash.

Finally, to the extent that a customer does not receive the full value of the claim against the failed FCM, that customer will have a deficiency claim for that amount. Since customer property is supposed to be segregated, significant deficiency claims should only arise where the property in the customer's account was lost, stolen, misappropriated or improperly hypothecated.[9] However, if the bankrupt FCM and the customer relationships are sold as a block to a third party purchaser, then the affected customer relationships will be transferred as a whole and will ultimately be unaffected by the liquidation (as was generally the case in some of the acquisitions described below).

A trustee has certain avoidance powers under the Bankruptcy Code to avoid transfers of property of the FCM made to customers during a certain time period before the bankruptcy filing. These avoidance powers could theoretically implicate any withdrawals or transfers that customers make immediately before the FCM files for bankruptcy. However, under regulations promulgated by the Commodity Futures Trading Commission (the Commission or CFTC), a bankruptcy trustee may not avoid transfers of commodity accounts made prior to the entry of an order for relief[10] if: (1) the transfer is made by a "public customer" (see below for definition); (2) the customer did not act in collusion with the debtor; and (3) the transfer is not disapproved of by the Commission.[11] A public customer includes any customer (as defined in the Bankruptcy Code) other than: (i) a proprietary account; (ii) an eligible contract participant that opted against having his or her funds segregated by the FCM (which option is only available for funds trading on or through the facilities of a registered derivatives transaction execution facility (DTEF)[12] or (iii) a proprietary leverage account.[13] Therefore, absent collusion or Commission disapproval, an FCM customer may transfer its commodity accounts prior to a bankruptcy filing by that FCM or adjudication of bankruptcy without concern that the liquidating trustee will seek to avoid the transfer[14] so long as the commodity account is not proprietary, unsegregated at the option of the customer, or a leverage proprietary account.

After the filing of a bankruptcy petition, certain transfers may also be made by: (i) the trustee of the commodity broker (*i.e.*, the FCM); or (ii) any self-regulatory organization (SRO)[15] or (iii) the clearing organization of the FCM (the post-relief entities). Specifically, the post-relief entities may transfer a customer account within four business days[16] of the entry of the order for relief if the customer account is: (1) not a commodity account owned by the debtor; (2) not a leverage account (provided that this restriction only applies if the debtor is

a leverage transaction merchant);[17] (3) not a dealer option account (subject to certain exceptions); (4) contains open commodity contracts and (5) not in deficit.[18] However, no transfer will be permitted in this situation if the value of the assets transferred would exceed the funded balance of the account from which it originated.[19] Therefore, the commodity broker's trustee, an SRO or the FCM's clearing organization may transfer any customer accounts described above within four business days of an order for relief.

Of note, unless a customer's account is traded on or through a DTEF, customer funds deposited with an FCM are required to be segregated.[20] An FCM may commingle customer funds with those of other customers, but cannot commingle customer funds with its own funds.[21] FCMs are permitted to invest customer funds in certain approved types of investments,[22] but they must make up any losses stemming from instruments purchased with customer funds.

Because customer funds are required to be segregated and are protected in various other ways, and because customers have wide latitude for transferring and withdrawing funds prior to an FCM's bankruptcy, FCM customer positions are often transferred from failing FCMs to a solvent transferee without complication. Indeed, clearinghouses (*i.e.*, DCOs) will often begin looking for other FCMs to take positions held by a failing FCM. However, FCM customers may experience difficulty transferring or withdrawing FCM accounts if the FCM failed to actually segregate customer account, as illustrated by the Sentinel example, below. Additionally, as noted above, the Commission has the right to disapprove of any transfers (and withdrawals), so DCOs searching for other FCMs often do so in collaboration with the CFTC.[23]

Please note that this memorandum primarily addresses transfers and withdrawals *prior* to the filing or adjudication, as the case may be, of a petition for bankruptcy. While transfers are possible after such a filing or adjudication, the CFTC regulations provide a detailed method for a trustee to allocate the property of a debtor's estate following an entry of an order of relief.[24] Further information regarding this post-bankruptcy allocation will be provided upon request.

Review of Previous FCM Bankruptcies

Relatively few FCMs have declared bankruptcy. In 2007, for example, the NFA wrote that there had only been five FCM insolvencies since 1990.[25] One of those bankruptcies was the bankruptcy of Refco LLC in 2005. Since the NFA's comment, notable bankruptcies of organizations that had FCMs include Sentinel Management Group (in 2007) and Lehman Brothers Inc. (in 2008).

In general, the futures positions in these cases were transferred to solvent FCMs without much trouble. For example, a group of market participants organized at the behest of the Federal Reserve Bank of New York to explore issues surrounding the portability of credit default swap positions wrote that:

> in the case of Lehman Brothers Inc. (an FCM), customers were able to transfer their positions and associated margin to other FCMs, even after the parent company (Lehman Brothers Holdings Inc.) had filed for bankruptcy. Customer accounts and associated margin remaining when Lehman Brothers Inc. entered liquidation were transferred in bulk to Barclays Capital Inc. (also an FCM). The transfers were generally conducted in an expedited fashion without any material issues.[26]

During the Refco LLC bankruptcy, all futures positions were sold in one piece (to Man Financial, the predecessor to MF Global) immediately upon the bankruptcy filing.[27] While

the customers of several subsidiaries experienced significant losses from the Refco bankruptcy, customers of Refco's regulated business were largely unaffected.[28]

Therefore, customers of FCMs are typically well-protected in the event that the FCM files for bankruptcy, due to the protections afforded to futures positions by requiring segregation of customer funds.

However, if an FCM fails to segregate customer funds as required by CFTC regulations, customers may have difficulty transferring or withdrawing those accounts, especially after the FCM's bankruptcy. For example, when Sentinel Corporation filed for bankruptcy, its FCM sold most of the accounts in one of its major segregated accounts (the Seg 1 Account) to Citadel. The bankruptcy trustee and certain other customers of Sentinel, however, argued against permitting that sale because Sentinel had allegedly commingled funds from the Seg 1 Account with the FCM's own assets and assets in other segregated account.[29] According to the trustee and certain other customers, it was therefore impossible to know whether the funds in the Seg 1 Account at the time of Sentinel's bankruptcy were, in fact, the assets of the Seg 1 customers.[30] The Seg 1 Accounts have still not been distributed.

Similar complications can arise if the FCM's segregated accounts are insufficient to honor the redemption requests of all of the customers. For example, the CFTC alleged that Sentinel engaged in fraud and misuse of segregated customer funds prior to filing for bankruptcy.[31] As a result, according to the CFTC, Sentinel owed its Seg 1 customers $130 million after selling that account to Citadel. In these situations, FCM customers may be unable to receive all of the assets they had deposited with the FCM.

Endnotes

1 *See* UCC § 9-102(14).

2 *See* 11 U.S.C. § 761(4).

3 SIPA liquidations traditionally are brought in the Bankruptcy Court, so there is little if any practical distinction between a SIPA liquidation and a pure Chapter 7 liquidation.

4 Customer Property is defined in part as "cash, a security, or other property, or proceeds of such cash, security, or property, received, acquired, or held by or for the account of the debtor, from or for the account of a customer . . ." 11 U.S.C. § 761(10).

5 Generally an FCM would file for liquidation under chapter 7 of the Bankruptcy Code, but in this case Holdings is being administered by a trustee whose appointment was requested by the Securities Investment Protection Corporation to be administered under SIPA.

6 *See* National Futures Association, *How is my Futures Account Protected?, available at* http://www.nfa.futures.org/nfa-faqs/investor_information_faqs/trading-futures-options-on-futures-and-forex/how-is-my-futures-account-protected.HTML. Customer funds are not subject to creditor claims because the FCM holds only legal title and not equitable title to such funds.

7 *See* 11 U.S.C. § 766(c)

8 *See* 17 C.F.R. § 190.07. The regulations promulgated by the Commodity Futures Trading Commission dictate how a customer calculates his claim against the insolvent FCM.

9 Since Net Equity Claims are frozen as of the commencement of the liquidation, deficiencies could arise where the value of customer property declines following the commencement but prior to sale. In addition, the customer will not receive any benefit from the post-commencement appreciation of the assets in its account.

10 An "order for relief" means the filing of the petition in bankruptcy in a voluntary case and the adjudication of bankruptcy in an involuntary case. 17 C.F.R. § 190.01(dd).

11 *See* 17 C.F.R. § 190.06(g)(1)(ii).

12 Note that there are no DTEFs in existence at this time since no DTEFs have registered with the CFTC.

13 *See* 17 C.F.R. §§ 190.01(hh); (bb) (defining "public customer" and "non-public customer," respectively).

14 Depending on whether the bankruptcy is voluntary or involuntary. *See* supra note 10.

15 *I.e.*, the NFA.

[16] Specifically, the transfer must be made on or before the close of business on the fourth business day after the entry of the order for relief. 17 C.F.R. § 190.06(g)(2)(i)(A).

[17] Note, currently there are no leverage transaction merchants ("LTMs") registered with the CFTC.

[18] *See* 17 C.F.R. §§ 190.06(g)(2); (e)-(f).

[19] *See* 17 C.F.R. § 190.06(e)(2).

[20] *See* 17 C.F.R. § 1.20(c) ("Each futures commission merchant shall treat and deal with the customer funds of a commodity customer or of an option customer as belonging to such commodity or option customer. All customer funds shall be separately accounted for, and shall not be commingled with the money, securities or property of a futures commission merchant or of any other person. . . .").

[21] *See* 17 C.F.R. § 1.20(a).

[22] *See* 17 C.F.R. § 1.25(a).

[23] The information in this paragraph is derived from a discussion with a source familiar with these types of transfers.

[24] *See*, *e.g.*, 17 C.F.R. § 190.08 ("Allocation of property and allowance of claims.").

[25] *See* National Futures Association, Explanation of Proposed Amendments, *available at* http://www.nfa.futures.org/news/newsProposedRule.asp?ArticleID=1941.

[26] Report To The Supervisors Of The Major OTC Derivatives Dealers On The Proposals Of Centralized CDS Clearing Solutions For The Segregation And Portability Of Customer CDS Positions And Related Margin at 6 n.19 (June 30, 2009), *available at* http://www.isda.org/credit/docs/Full-Report.pdf.

[27] *See* Letter from Albert Togut to David A. Stawick, Secretary of the CFTC (Jan. 14, 2010) (describing Togut's actions as Trustee of Refco LLC).

[28] *See* Managed Futures Today, *Safeguarding Customers Through Segregated Funds* at 4 (Feb. 2011) ("In 2005, Refco Inc. and 23 of its unregulated subsidiaries filed for Chapter 11 bankruptcy protection. However, Refco's regulated subsidiaries (where customers' futures trading and managed futures accounts resided) were unaffected and customers were able to continue trading and managing their accounts.").

[29] *See* Grede v. Fortis Clearing Americas LLC, No. 09 C 138, 2009 WL 3518159 at *2 (N.D. Ill. Oct. 28, 2009) (discussing trustee's proceedings against Seg 1 Defendants).

[30] *See id.* at *3 ("Trustee argues Defendants cannot identify a res given the massive commingling and misuse of funds, and 'a tracing fiction should not be employed to elevate [Defendants' claims] over the claims of other creditors if those creditors are similarly situated.'").

[31] *See* CFTC, Press Release (May 1, 2008), *available at* http://www.cftc.gov/PressRoom/PressReleases/pr5494-08.

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