CLIENT ALERT
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Entering Uncharted Waters: MF Global liquidation presents unprecedented test of U.S. insolvency regime for dual registrants

- *MF Global represents first significant liquidation of a brokerage firm jointly registered as a broker-dealer with the SEC and a commodity broker with the CFTC*
- *Liquidation of MF Global will require the unprecedented application of two distinct bankruptcy and customer asset protection regimes that lack harmonization*
- *Over 40 of the 50 largest commodity brokers are dually registered as broker-dealers*

Overview

Even in these early days, the collapse of MF Global is proving significant for a number of reasons. In addition to being one of the ten largest bankruptcies in U.S. history, MF Global's collapse potentially involves missing customer assets amounting to hundreds of millions of dollars. In the long run, however, one of the larger distinctions may prove to be that the liquidation of MF Global will require the unprecedented application of two vastly different bankruptcy and customer asset protection regimes to a sizeable brokerage firm.

Starkly Different Insolvency Regimes for U.S. Broker-Dealers vs. Commodity Brokers

The U.S. securities and futures regimes differ greatly on the procedures to be followed in the event of the insolvency of a registered broker.

- U.S. securities laws create an insurance system that requires an SEC-registered stockbroker, or broker-dealer ("BD"), to join the Securities Investor Protection Corporation ("SIPC"). SIPC collects fees from its members to create a reserve

fund that can be used to reimburse customer losses (up to a maximum of $500,000 per customer) in the event of a BD insolvency. BDs are therefore typically liquidated in accordance with the provisions of the Securities Investor Protection Act ("SIPA"), and a SIPC-appointed trustee oversees the liquidation. In addition the SEC's customer protection rules require brokers to (1) have physical possession or control of all fully-paid securities and excess margin securities carried for customers, and (2) to maintain a special reserve bank account for the exclusive benefit of customers in which the BD must maintain an amount of funds calculated in accordance with a formula specified in SEC rules.

- In contrast commodities brokers are liquidated in accordance with the provisions of Subchapter IV of Chapter 7 of the U.S. Bankruptcy Code. This regime does not provide for SIPC-type insurance protection but instead requires CFTC-registered commodity brokers, or futures commission merchants ("FCMs"), to segregate customer funds from the funds of the FCM in a separate bank account that is clearly designated as belonging to customers. Segregation in this manner is intended to ensure that, in the event of an FCM bankruptcy, customer funds can be identified as such and will not be available to other creditors of the FCM. A trustee overseeing the liquidation of an FCM is required to apply the CFTC's "Part 190" rules for FCM insolvencies, which call for the determination of various account classes that govern the manner in which the trustee calculates the amount of each customer's claim against an insolvent FCM.

Insolvency of Lehman Brothers Inc. – Dodging a Bullet

The conflicts between the securities and futures regimes for insolvent brokers were nearly put to the test when Lehman Brothers Inc. ("LBI")—also a dually registered BD/FCM—failed in 2008. A potential crisis was avoided because the sale of LBI's futures business to Barclays Capital was fortuitously arranged shortly before LBI's liquidation proceeding was commenced by SIPC on September 19, 2008. As a result, the trustee for the LBI liquidation (who happens to be the same trustee for MF Global) applied only the SIPC regime when unwinding LBI and did not contend with applying the CFTC insolvency regime for FCMs simultaneously.

The lack of harmonization between the securities and futures regimes was not lost on the Obama Administration after Lehman's failure. On June 17, 2009, the Administration released a white paper on financial regulatory reform (the "White Paper") outlining a plan for comprehensive reform in order to restore confidence in the integrity of the U.S. financial system. Noting that "[t]he broad public policy objectives of futures regulation and securities regulation are the same: protecting investors, ensuring market integrity, and promoting price transparency," the White Paper requested that the SEC and the CFTC identify "all existing conflicts in statutes and regulations with respect to similar

types of financial instruments and either explain why those differences are essential to achieve underlying policy objectives with respect to investor protection, market integrity, and price transparency or make recommendations for changes to statutes and regulations that would eliminate the differences."

Hearings were organized shortly thereafter, and, prophetically, NYSE Euronext's Larry Leibowitz, in testimony at a joint SEC-CFTC hearing on harmonizing market regulation, urged regulators not to assume that they will always be able to achieve the fortunate outcome obtained with LBI. "[W]e cannot assume that our luck will continue to hold. In the absence of a complete overhaul of the provisions of the Bankruptcy Code relating to the liquidation of stockbrokers and commodity brokers, it is essential that the SEC and CFTC develop procedures to guide a trustee, as well as the Bankruptcy Court, when a joint BD/FCM becomes insolvent."[1]

At the same hearing Chairman of the Chicago Board of Options Exchange William Brodsky agreed that greater harmonization was needed. "This disparity poses conflicting insolvency treatments for an entity that is both a broker-dealer and a FCM. It also complicates efforts to address default or malfeasance by a large market participant … In harmonizing the futures and securities laws, attention should be given to whether the bankruptcy structures should continue to be so dramatically different for securities and futures accounts. If the two separate structures are kept in place, then attention should be given to how best to reconcile the differences when a dual broker-dealer/FCM becomes insolvent."[2]

Calls for Harmonization Largely Unheeded

Although the challenges that would be presented by applying two different bankruptcy regimes to a single legal entity have been recognized, recommendations for harmonization have not been implemented in any meaningful way to date.

The U.S. House of Representatives did pass a financial services reform bill in 2010 that would have instructed the CFTC, the SEC and the primary bank regulatory authorities to recommend, within 180 days of the bill's enactment, legislative changes to clarify and harmonize insolvency laws applicable to entities that are dually registered BD/FCMs. That particular provision was later dropped, however, and did not become law.

In a letter dated January 15, 2010, the Futures Industry Association ("FIA") urged the CFTC and other regulatory authorities to perform a comprehensive review of the

[1] Testimony of Larry Leibowitz, NYSE Euronext, before Joint Public Meeting of the CFTC and SEC, September 2, 2009.

[2] Testimony of William J. Brodsky, Chairman and Chief Executive Officer, Chicago Board Options Exchange, before Joint Public Meeting of the CFTC and SEC, September 2, 2009.

relevant provisions of the U.S. Bankruptcy Code to achieve greater harmonization, noting that (like MF Global) 43 of the 50 largest FCMs were also registered broker-dealers. FIA also recommended that the CFTC, SIPC and the SEC work together to develop uniform written guidance for a trustee of an insolvent BD/FCM. In response the CFTC stated that it believed that "the development of specific uniform procedures may be impracticable due to the differences between the regimes and to the fact that each bankruptcy has its own unique set of facts and circumstances."[3]

Complex Questions

The MF Global liquidation raises several questions that did not arise with LBI. For example, it has been reported that MF Global had approximately 50,000 futures customer accounts and just 400 securities customer accounts. Given that the substantial majority of the firm's business was futures-related, should SIPC be appointing the trustee to oversee the liquidation as the current regime for dual registrants requires?

Although a SIPC trustee for an insolvent BD/FCM is required by SIPA to apply the broker-dealer insolvency regime together with the commodity broker insolvency regime, it is only required to do so to the extent that the trustee's duties under the commodity regime are consistent with SIPA.[4] Given the inconsistencies between the two regimes, will a SIPC trustee be able to apply the commodity broker insolvency regime "consistent with" SIPA as a practical matter?

The potential impact of malfeasance on customer recovery from an insolvent BD/FCM is another issue that these conflicting regimes fail to address with clarity. If customer funds were inappropriately diverted from an insolvent broker's commodity futures customer accounts but not the securities customer accounts, should the futures customers bear the resulting losses alone? Or should customers of a failed BD/FCM share ratably in losses induced by fraud?

Conclusion

Although addressing questions such as these and others related to the harmonization of the U.S. futures and securities regimes may present daunting challenges, the failures of MF Global and LBI underscore the importance of revisiting the potential benefits of developing a more consistent customer asset protection regime that balances the interests of protecting customer assets as well as the integrity of the financial markets in the event of the failure of a major brokerage firm.

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[3] *See* CFTC Final Rules on Operation, in the Ordinary Course, of a Commodity Broker in Bankruptcy (75 FR 44890, at 44892) (July 30, 2010).

[4] *See* Securities Investor Protection Act of 1970 § 7(b), 15 U.S.C. 78fff–1(b).

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