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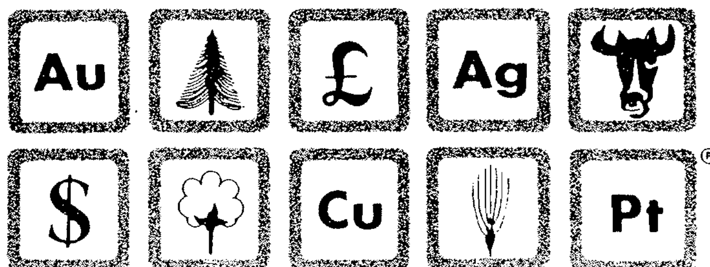

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Bankruptcy Pitfalls For Dually-Licensed Brokerage Firms

By: Andrea M. Corcoran

Introduction

The experience of the futures markets with bankruptcy has been exemplary. Since adoption of the Commodity Exchange Act ("CEA") in 1936, notwithstanding the absence of an insurance program covering customer losses, no exchange member firm default has resulted in a loss (other than the opportunity cost of delayed distribution) of a single dollar of customer funds.[1] As early as 1980, however, concerns were expressed about the ability to retain this record in the event of the bankruptcy of a dually-licensed firm—that is, a firm registered as both a futures commission merchant ("FCM") and a securities broker-dealer.[2] At that time technical amendments were being considered to the provisions of the Bankruptcy Code ("Code") added by the Bankruptcy Reform Act of 1978, which for the first time specifically addressed futures as well as securities firm bankruptcies.

A primary goal of the special futures or commodity liquidation provisions of Subchapter IV of Chapter 7 of the Code is to prevent commodity broker bankruptcies from having a "ripple effect" that could threaten the integrity of the futures markets.[3] To foster this goal, the Commodity Futures Trading Commission's ("CFTC" or "Commission") regulations (*see, e.g.*, 1.17(a)(4), 17 C.F.R. §1.17(a)(4)) generally mandate the transfer of customer accounts when an FCM's capital has become impaired, and the Bankruptcy Code and the Commission's regulations provide explicit protection against attack of such pre-bankruptcy transfers and certain post-bankruptcy transfers in a bankruptcy case.[4] Although strong incentives exist for moving customer accounts from troubled futures firms prior to bankruptcy,[5] and the transfer mechanism of the Code has

(continued on page 2)

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[1] Total firm insolvency losses also have been small. As of November 11, 1991, the CFTC reported that total losses for the more than fifty-year period beginning in 1938 were approximately $11.5 million. Compare the Securities Investor Protection Corporation ("SIPC") plan to increase its insurance fund reserves to $1 billion by 1997. 24 Securities Reg. & L. Rep., 1576 (October, 1992).

[2] To date, although some dually-registered firms have failed, either their actual business activities were limited to securities only, or futures only, or all futures customers accounts were transferred before any petition in bankruptcy was filed.

[3] *See* H.R. Rep. No. 595, 95th Cong., 1st Sess. 271-272 (1977); S. Rep. No. 989, 95th Cong., 2nd Sess. 7-8 (1978).

[4] *See* 11 U.S.C. §764(b)(1); 17 C.F.R. §190.06(g)(i). *See also* 11 U.S.C. §546(e).

[5] In the Stotler and Company, Inc. ("Stotler") and Drexel Burnham Lambert, Incorporated ("Drexel") cases more than $650,000,000 in customer funds and approximately 70,000 active customer accounts were transferred to healthy firms before the futures commission merchant/broker-dealer component of the troubled financial services group filed for bankruptcy. In the Drexel case, all affected regulators cooperated in handling the wind-down of the financial group and it was possible to liquidate cash positions in tandem with futures positions, thereby reducing overall risk during the liquidation process.

In this issue

1 | **Bankruptcy Pitfalls For Dually-Licensed Brokerage Firms** by Andrea M. Corcoran
7 | **Personal Notes**
7 | **Recent Books of Interest**
8 | **Upcoming Conferences & Events**

The extraordinary and rapid demise of Stotler and Company and Drexel Burnham Lambert focused attention upon the interface between the federal bankruptcy laws for futures firms and securities firms. Federal financial market regulators have been especially concerned with the intricate and sometimes conflicting schemes for futures brokers on the one hand, and securities brokers, on the other, and the Market Reform Act of 1990 directed the Securities and Exchange Commission to conduct a study of the potential legal problems arising from the insolvency of a full-service brokerage firm. The above article by Andrea Corcoran, Esq., the Director of the CFTC's Division of Trading and Markets, charts the critical divide between the bankruptcy laws for security and commodity firms. She reports that multi-agency discussions among regulators is making some progress towards developing a rational resolution of the conflicting laws, though there is still more work to be done.

been phenomenally successful in addressing protection of customer funds, problems could arise with implementing this mechanism because of the two legal regimes affecting dually-licensed firms.[6]

Currently, separate and potentially divergent procedures exist under the Bankruptcy Code and the Securities Investor Protection Act ("SIPA") for liquidating securities and futures businesses.[7] This fact, and the fact that only securities accounts, and not futures accounts, are insured may create practical and legal difficulties in the case of a joint bankruptcy.[8] Neither Subchapter III of the Code (the broker-dealer subchapter), nor Subchapter IV (the commodity broker subchapter), nor SIPA itself, make clear how the different procedures, including the transfer procedures, which they contain are to be harmonized when a bankrupt firm is both a commodity broker and a broker-dealer.

The Commission identified the confusion which could result from these differences when it began in 1981 to draft the bankruptcy rules now contained in Part 190[9] of its regulations.[10] At that time, the Commission's assessment was that the particular problems of a firm engaged in both securities and futures brokerage activities were best handled on a case-by-case basis.[11] In the final rules, the Commission noted that Section 7(b) of SIPA (15 U.S.C. 78fff-1(b)) provides that a trustee in a SIPA liquidation shall be subject to the same duties as a trustee in a commodity broker bankruptcy under Subchapter IV of Chapter 7 of the Code. The Commission went on to state its concern, however, that "the potential for an interpretation giving only limited recognition to Subchapter IV under SIPA may well raise problems in implementing that Subchapter in a joint bankruptcy."[12] In adopting its final bankruptcy rules, the Commission thus advocated pursuing further discussions to develop an agreed joint approach.[13]

Currently, such discussions are being conducted by the Bankruptcy Liquidation Subgroup of the Market Transactions Advisory Committee ("MTAC") mandated by the Market Reform Act of 1990 (15 U.S.C. §78q-1(f)(4)(A) (West Supp. 1992)) and convened by the Securities and Exchange Commission ("SEC") for the first time on October 29, 1991. Pending the conclusion of these deliberations, it is worth revisiting the issues identified by the Commission when it promulgated its special commodity broker bankruptcy rules in 1983 which may have implications for these discussions.

[6] *See, also* 46 *Fed. Reg.* 57535,57545-46 (November 24, 1981) for a discussion of the benefits of pre-bankruptcy transfers.

[7] Like commodity brokers, securities broker-dealers generally may not use Chapter 11 (the reorganization chapter of the Bankruptcy Code). Rather, securities broker-dealers are liquidated either under Subchapter III of Chapter 7, 11 U.S.C. §741 *et seq.*, or, as is more often the case, under SIPA, 15 U.S.C. §78aaa *et seq.*

[8] Although futures accounts are not insured, customers of a commodity broker are afforded "special protection" under the commodity broker liquidation provisions of the Bankruptcy Code (Subchapter IV of Chapter 7, 11 U.S.C. §761, *et seq.*). *See* H.R. Rep. No. 595, 95th Cong., 1st Sess. 319 (1977). The principal special customer protection afforded by these provisions is a priority over non-customer creditors in the distribution of "customer property." *See* 11 U.S.C. §766(h). *See also* 11 U.S.C. 761(10) (defining "customer property").

[9] 17 C.F.R. Part 190.

[10] 46 *Fed. Reg.* 57535 *et seq.*

[11] "It appears to the Commission that the problems of a joint commodity broker - security dealer (sic) are best handled on a case by case basis because of the difficulty of adequately anticipating the issues which will need to be addressed [and] the likelihood that each such bankruptcy will be unique and that many different and competing interests [will be] involved." *Id.* at 57553

[12] 48 *Fed. Reg.* 8716 at 8720 (March 1, 1983).

[13] *Id.* at 8719-20.

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Statutory Background

Section 60e, the section of the former bankruptcy law (dating from 1938) which dealt with broker-dealer bankruptcies,[14] inspired the concept of a separate bankruptcy subchapter applicable to the liquidation of so-called "commodity brokers." (For purposes of this discussion, commodity brokers are futures commission merchants that actually carry customer positions,[15] even though the Code also defines leverage transaction merchants and clearing organizations as commodity brokers.)

In the Bankruptcy Reform Act of 1978, Congress fashioned special commodity liquidation provisions with unique and unprecedented market protections built into them. The most novel of these were: (1) the protection of margin payments from reversal as preferences (11 U.S.C. §764(c) (now §546(e))), and (2) the provisions calculated to permit the transfer of open futures positions and the free credit balances supporting or securing those positions (11 U.S.C. §§764(b) and 766). The Act's approach to firm bankruptcies was so tailored to the special needs of the futures markets and their customers that the former Section 60e model was barely recognizable. Indeed, for the first time the legislators sought to adopt Code provisions which would balance the public policy of protecting the financial markets from systemic problems with the historic bankruptcy policy of debtor and general creditor protection from the need for a creditors' race to salvage their interests.

To some extent, necessity was the mother of these inventions. Because the futures industry and the Commission had rejected the idea of account insurance for futures customers in 1974, and again in 1976, the Commission looked only to the existing regulatory fail-safe system (primarily the segregation of customer funds under Section 4d of the CEA[16] and the clearing organization counterparty guarantee) as the protective scheme which could make customers whole and keep the financial markets safe in the event of a bankruptcy.[17] Theoretically, assuming full compliance with the Commission's segregation requirements, under the Bankruptcy Code's commodity subchapter no customer or trade partner of a commodity broker need fear the dislocations of a bankruptcy. The transfer provisions would permit the transfer of all accounts which contain any open positions, thus facilitating continuing payments on such open positions. The margin protections would make previous transfers of margin to other participants in the market chain inviolate. Business (albeit through another broker) would proceed as usual.

The merits of the market protections suggested by the Commission were self-evident. So self-evident, in fact, that the imitators became the imitated. The securities industry immediately demanded "equal protection" in bankruptcy of margin payments between a customer and a securities firm, and between securities firms. These demands were codified as §546(e) and §555 which were first added as technical amendments to the Code in 1982. Subsequently, similar legislation was passed in 1984 to protect repurchase agreements (*See, e.g.*, 11 U.S.C. §§546(f), 559) and in 1990 to protect swaps (*See, e.g.*, 11 U.S.C. §§546(g), 560), among other transactions.

As noted above, unlike futures firms, securities firms rely heavily on insurance to avoid the ill effects of bankruptcy on customers. The Securities Investor Protection Act, adopted in 1970 in response to a substantial broker-dealer bankruptcy, and materially amended in 1978, provides customer account insurance for customers of virtually all non-bank broker-dealers whose principal place of business is in the United States, its territories or possessions. If invoked, apparently SIPA supersedes the provisions of the Bankruptcy Code relative to securities firms except for those general provisions (that is, the provisions in Chapters 1, 3 and 5 and Subchapters I and II of Chapter 7) which are not inconsistent with SIPA.[18]

Experience With the Law

Even with the innovative and much copied market and customer protections of Subchapter IV, a futures bankruptcy may be complex. Full segregation is rarely a characteristic of bankrupt futures firms. For example, Incomco, Inc. was at least $2 million undersegregated when it filed for bankruptcy August 1, 1980. Although the Code permits transfers of positions which are partially funded, these are more complex to undertake than the transfer of positions fully-secured at the carrying firm. Moreover, even a fully-segregated firm can fail under circumstances which would give rise to a shortfall of customer funds.[19] This is because a customer default which exceeds the carrying debtor's capital would, to the extent that the carrying firm could not make up the defaulted amount,[20] result in a corresponding shortfall after exercise by the clearing organization of its rights with respect to margin deposited at the clearing house by such firm on behalf of customers generally.[21] (For example, the Volume

[14] Act of June 22, 1938, Ch. 575 §60(e), 52 Stat. 840,870-871, formerly codified at 11 U.S.C. 96(e).

[15] 11 U.S.C. §101(6).

[16] 7 U.S.C. §6(d).

[17] In general, futures clearing organization guarantee funds effectively guarantee performance to counterparties of a failed firm by taking the opposite side of any transaction (that is, becoming the "buyer" to every seller and the "seller" to every buyer) when the trade is cleared.

[18] 15 U.S.C. §78eee(b)(2); and 15 U.S.C. §78fff(b). *See, also,* 11 U.S.C. §742 and 11 U.S.C. §§103(c) and (d). This is one reason that the futures margin protection provisions originally contained in Subchapter IV in the 1978 Act were moved to Chapter 5 in 1982. The account transfer provisions remain in the sections of Chapter 7 specifically devoted to commodity broker bankruptcies.

[19] It should be noted in this connection that securities margin accounts are not fully segregated, so that the potential for a run on a securities firm and complications in a pending liquidation proceeding from shortfalls would be greater than for a fully segregated futures firm, even with account insurance. *Compare* §4d(2), 7 U.S.C. §6d and Rule 1.20, 17 C.F.R. §1.20 with §15(c)(3) of the Securities Exchange Act of 1934, 15 U.S.C. §780(e)(3) and Rules 15e 3-2 and 15e 3-3, 17 C.F.R. §240.15e 3-2 and §240.15e 3-3.

[20] *See* A. Corcoran and S. Ervin, *Maintenance of Market Strategies in Futures Broker Insolvencies: Futures Position Transfers from Troubled Firms*, 44 Washington and Lee Law Review, 849,865-868 (1987).

[21] CFTC Interpretative Statement 85-3, *Use of Segregated Funds By Clearing Organizations Upon Default By Member Firms* [1984-1986 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶22,703 (Office of General Counsel) (August 12, 1985).

Investors Corporation failure in 1985 left that fully-segregated firm almost $2 million short after the clearing organization satisfied itself out of margin it held on behalf of customers of Volume generally.) Further, the trustee in bankruptcy may not be willing or able to implement the account transfer provisions and the Commission has no clear vehicle to exercise its authority to do so on the trustee's behalf. (For example, in the Stotler bankruptcy, the trustee reversed funds drawn on the firm that were in transit to customers prior to a voluntary bankruptcy filing because of an anticipated, but disputed, claim to share in customer funds by certain Stotler pools.)[22] Therefore, even if no questions arise concerning the applicability of Subchapter IV, the ease of its implementation may depend on full, or nearly full, segregation and no surprise customer claimants. If, in addition, the bankrupt futures firm is one of the 57 that are also broker-dealers and carry customer funds, and such futures firm not only is registered to do securities business but also *actually* engages in such business, there may be questions as to how and/or whether the protections of Subchapter IV will be applied.

The Issues

The following are some of the potential issues that were identified by the Commission in 1983 concerning the administration of joint commodity-broker/broker dealer estates which deferrence to its Part 190 rules could potentially address.

(1) Disputes Concerning the Effect of an SIPA Proceeding on the Commodity Related Assets of a Joint Commodity Broker/Broker-Dealer.

Section 742 of Subchapter III of Chapter 7 of the Bankruptcy Code provides that the filing of an application for a protective decree under SIPA "stays all proceedings in a case under *this title* unless and until such application is dismissed." (*Emphasis added.*)[23] SIPC may seek a protective order for any member (basically all non-bank broker-dealers except firms engaged exclusively in the sale of mutual funds, the sale of variable annuities, the business of insurance, or the furnishing of investment advice to insurance and investment companies) which has failed or is in danger of failing to meet its obligations to customers, if that member firm is (1) insolvent, using an asset test; (2) is the subject of a proceeding before any agency of the United States, or any State, or which is pending in any court, in which a trustee, a receiver, or a liquidator has been appointed; (3) is not in compliance with the 1934 Act and the regulations of the SEC or any self-regulatory organization with respect to the financial responsibility or hypothecation of customers' securities; or (4) is unable to make the computations necessary to establish compliance with the foregoing.[24]

It is likely that a protective order would be sought by SIPC when there is a joint commodity broker/broker-dealer bankruptcy. Such an order would automatically stay any proceedings and thus could be claimed to preclude those transfers to futures customers permitted under Subchapter IV at any time prior to, and up to five days after, entry of an order of relief. Implementation of Section 742, then, may well be a potential obstacle to exercise of the Commission's authority to immunize transfers made within the five-day post-bankruptcy statutory period from collateral attack, because the stay effected by Section 742 may prevent such transfers intended to protect customers and the markets from ever taking place.[25] In that case, the Commission would doubtless argue that transfers are not "proceedings" and therefore should not be stayed by Section 742. But, the trustee appointed in the SIPA proceeding may have a different view of its obligations to the debtor's estate.

Further, Section 742 suggests that a SIPC trustee or liquidator may have the authority to liquidate the entire estate of a joint commodity broker/broker-dealer because of its securities business. That section states that *all* proceedings under title 11 are stayed, not just proceedings under Subchapter III which is the securities subchapter. Should a trustee assert this view, the Commission could attempt to secure a dismissal of the SIPA proceeding as to the futures portion of the debtor's business. The SIPA trustee or liquidator, however, would doubtless resist such a dismissal because of the representative of the securities estate's obvious interest in maximizing recovery to the securities customers whose claims SIPC insures.

All of this suggests that, at a minimum, some means should be developed to assure that such SIPA trustees obtain necessary expertise about the management of the futures side of the business in a joint case. Indeed, effective management of the financial situation of dually-licensed firms may depend on the ability of the trustee to take advantage of those provisions of Subchapter IV intended to reduce the risks to the marketplace of a futures firm's liquidation and to maximize the potential for futures customer recovery including, in particular, implementation of the transfer provisions to the fullest extent.

(2) Disputes Concerning Which Customers Have Priority With Respect to a Joint Commodity Broker/Broker-Dealer's General Estate.

In the case of a debtor who is involved in both securities and futures businesses, the Bankruptcy Code potentially

[22] *CFTC v. Stotler Funds, Inc.*, Civil Action No. 90C4387 (N.D. Ill.) (Shadur, J.) (January 4, 1991, not reported).

[23] This is true even though 11 U.S.C. 556 permits clearing liquidations on the futures side notwithstanding the automatic stay under the Code to occur without interference from any person, including a Court or the CFTC. *Compare* 11 U.S.C. §555.

[24] 15 U.S.C. §78eee(b)(1).

[25] 11 U.S.C. §764(b) reads as follows:

Notwithstanding sections 544, 545, 547, 548, 549, and 724(a) of this title, the trustee may not avoid a transfer made before five days after the order for relief, if such transfer is approved by the Commission by rule or order, either before or after such transfer, and if such transfer is-

(1) a transfer of a commodity contract entered into or carried by or through the debtor on behalf of a customer, and of any cash, securities, or other property margining or securing such commodity contract; or

(2) the liquidation of a commodity contract entered into or carried by or through the debtor on behalf of a customer. *See, also,* Commission Rule 190.06(g, 17 C.F.R. 190.06(g).

could be read to create two customer priorities in the same funds. (*Compare* 11 U.S.C. §§741(4) and 752 with 11 U.S.C. §§761(10) and 766(h).) "Customer property" is described in the securities subchapter as cash, securities or other property received, acquired or held by the debtor for a customer's security account. Similarly, "customer property" is described in the commodity subchapter as cash, securities or other property received, acquired or held by the debtor for a customer's futures accounts. The Commission is given very broad authority to define customer property but the potential remains for there to be disputes as to whether cash or government securities that are basically fungible are held on behalf of futures or on behalf of securities customers. The records of the debtor might not be clear and, even if clear, although they should be dispositive as to which accounts free credit balances support, a dispute could nonetheless arise.[26]

SIPA liquidation procedures only establish a priority for customers of the debtor's securities business. SIPA provides, however, "To the extent consistent with the provisions of... [SIPA] or as otherwise ordered by the court, a trustee [in a SIPA liquidation] shall be subject to the same duties as a trustee in a case under Chapter 7 of the... [Code] including, if the debtor is a commodity broker...the duties specified in Subchapter IV of such Chapter 7...." (15 U.S.C. §78fff-1(b)). Conceptually, Subchapters III and IV of the Code are structured so that customer property can be distributed in two separate estates following either subchapter's mandate. In that the respective laws apply different valuation dates, mong other things, this seems advisable.[27]

Recent arrangements linking futures and securities markets programs, such as cross-margining, address this issue by specifically delineating the intended applicability of each law. In these cases, options and futures clearing member participants agree that joint cross-margin account funds, securities and property will be treated as customer property under the CEA and not under SIPA. The Commission endorses this position and has made it a condition of its orders approving non-proprietary cross-margining arrangements.[28] The SEC also has cited this language with approval in its orders.[29] It is hoped that the agreement of the regulators endorsed by the cross-margining orders as to the bankruptcy treatment of such accounts plus the existence of the authority for the bankruptcy court to honor subordination agreements[30] will cause the distribution contemplated by the orders to prevail.

The Bankruptcy Reform Act amended the CEA to accord the Commission substantial flexibility in formulating a definition of customer property.[31] In its bankruptcy regulations, the Commission seeks to provide more clarity by defining customer property (pursuant to its express authority to do so), to include, in addition to, among other things, actually segregated funds, and certain property recovered by the trustee:

> (G)...property of the debtor that any applicable law, rule, regulation, or order requires to be set aside for the benefit of customers, unless including such property in the customer estate would not significantly increase the customer estate;...[and] (J)...cash, securities or other property of the debtor's estate, including the debtor's trading or operating accounts and commodities of the debtor held in inventory, but only to the extent that the property enumerated in paragraphs (a)(1)(i)(E) and (a)(1)(ii)(A) through (a)(1)(ii)(H) of this section is insufficient to satisfy in full all claims of public customers.[32]

In explaining its new bankruptcy regulatory framework in 1983, the Commission had the following to say to support this definition which effects an extension of the customer priority to the general estate in cases where insufficient segregated funds are available to satisfy futures customer claims.[33] First, it noted that Congress specifically intended to reverse the result in the case of *In re Weis Securities, Inc.*, where only segregated property was accorded a customer priority and otherwise strict tracing was required for other property to be made available for customer distribution.[34] Second, it pointed out that the definition of "customer" for purposes of the Code includes certain persons who are not the firm itself, such as principals that are not general partners or sole proprietors, but that are defined as holders of proprietary accounts by Commission Rule 1.3(y) for whom property is not customarily segregated or required to be segregated.[35] Third, it noted that even if the shortfall in segregated funds was caused by a customer deficit resulting from default rather than outright conversion, the FCM holding that customer account would be obligated under the Act to restore the amount of the deficit to the account in which property is segregated on behalf of all public customers. An FCM is thus obligated to maintain proper segregation in the event of an insufficiency by drawing on its own funds or property. In effect, the Commission requires that an FCM must always have in segregation enough funds to satisfy all

[26] It is critical to transfers that some reliance be capable of being placed on account balances. For this reason, claims for fraud or unauthorized trading should not be treated as priority net equity claims, although they are claims against the estate. Commission rule 190.08(a)(2)(i) and (ii); 17 C.F.R. 190.08(a)(2)(i) and (ii).

[27] *Compare* the valuation dates specified in 11 U.S.C. §761(17) and 15 U.S.C. §78fff-2(b) and 2(c).

[28] *See, e.g.*, 2 Comm. Fut. L. Rep. (CCH) ¶25,191 (November 26, 1991), 56 *Fed. Reg.* 61404 (December 3, 1991).

[29] Securities Exchange Act Release No. 30041, 56 *Fed. Reg.* 64824 (December 5, 1991) and Securities Exchange Act Release No. 29991, 56 *Fed. Reg.* 61458 (Decem- er 3, 1991).

1 U.S.C. §510; *See also* 11 U.S.C. §746(b)(2).

[31] *See* section 20 of the CEA, 7 U.S.C. §24, which reads in pertinent part as follows:

> Notwithstanding title 11 of the United States Code, the Commission may provide, with respect to a commodity broker that is a debtor under Chapter 7 of title 11 of the United States Code, by rule or regulation -(1) that certain cash, securities, other property, or commodity contracts are to be included in or excluded from customer property.

[32] 190.08(a)(1)(ii)(G) and (J), 17 C.F.R. 190.08(a)(1)(ii)(G) and (J).

[33] 48 *Fed. Reg.* 8716,8717 *et seq.* (March 1, 1983).

[34] *In re Weis Securities Inc.*, [1975-1977 Transfer Binder] Comm. Fut. L. Rep. ¶20,108 (S.D.N.Y. 1975).

[35] *Compare* 11 U.S.C. 761(9) and Commission rule 190.01(k), 17 C.F.R. 190.01(k) with Commission rule 1.3(k), 17 C.F.R. §1.3(k).

customer claims must always have in segregation enough funds to satisfy all customer claims for money, securities or property margining, guaranteeing or securing futures or options positions held for or on their behalf and any accruals thereon.[36]

The Commission believed then and continues to believe that, as a consequence, its definition of customer property and of the scope of the customer priority is entirely consistent with the CEA and CFTC regulations as well as with the overall concept of the Code.[37] Under the Commission's treatment of customer property, the net equity claims of non-public customers still are treated as general creditor claims if the segregated "customer property" is insufficient to satisfy all public and non-public customers. The futures customer priority, which is based in part upon the legal premise that customer property is not the property of the debtor, also has been upheld in strong language by at least one federal court in connection with the Stotler bankruptcy.[38] That case, however, did not implicate any conflict under SIPA and the Code because, although dually-licensed, Stotler did no securities business.

Notwithstanding the legislative and judicial support for the Commission's view respecting the extent of the futures customer priority, any attempt to enforce the futures customers' priority in the general estate to the disadvantage of securities customers could meet resistance from a SIPC liquidator or trustee. Of course, a court may decide, in its discretion, to give uninsured customers a first priority in any event. A bankruptcy court would have sufficient power to effect that result.[39] Unfortunately, the matter may have to be litigated, which means time, expense, and potential dissipation of assets in administrative costs which should be available for distribution to either securities or futures customers. Such a dispute could also interfere with the ability to effect transfers on behalf of either customer type. An endorsement of the treatment of the customer-priority with respect to the general estate contained in the Commission's rules could facilitate protective account transfers.

In 1980, when the Commission was adopting its bankruptcy rules, there was a further threat that because securities insiders (in general, certain proprietary account holders)[40] were clearly subordinated to the claims of customers and futures insiders were not, firm insiders might strive to move their assets to futures accounts. This matter was resolved by the addition of a technical amendment to the Code, as requested by the Commission, which more clearly subordinated futures non-public customer claims.[41]

(3) Disputes Concerning the Inviolability of Pre-Bankruptcy Margin Payments.

Controversy also could arise as to whether a given margin payment should be treated as inviolate, particularly as the amount of margin set by a futures clearing organization or a firm may be set on a firm-by-firm or customer-by-customer basis and is not set by an independent third party as is securities margin. This could engender inquiries relative to whether the clearing institution or a clearing firm attempted to better its collateral position based on its knowledge of the debtor firm's or customer's financial condition in order to obtain a better result in the event of imminent bankruptcy. If so, it could be argued that the new margin requirement was a transfer voidable as not in good faith.[42] Of course, the very purpose of margin is to provide default protection from market risk—so such claims *should* be difficult to make. Nonetheless, if two parties are competing for the same collateral, it could happen.[43] This issue will likely remain for case-by-case resolution, but some acknowledgment that the Code's protections for clearing houses and clearing firms benefit counterparties as well would be helpful.

(4) Potential Conflicts Arising from the Fact That Only Securities Accounts are Insured.

Finally, as most lawyers and business people know, there is no surer impediment to a prompt insurance recovery than the presence of two complementary insurers whose coverage potentially applies to the same assets. This impediment—the potential for conflict—also can arise where there are two different protective schemes potentially applicable to the distribution of a debtor's estate, one based on insurance and one based on segregation coupled with a statutory priority. The insurer may want to limit the extent of any claim on its own funds. In contrast, the representative of the non-insured estate may argue that as the insured estate should be protected by insurance and the trustee should not seek to interfere on behalf of securities customers with futures customers' potential priority claim against the general estate.

At first glance, there does not appear to be any easy way to eliminate potential conflicts of this type in the event of a joint commodity broker/broker-dealer bankruptcy. Seemingly, the most practical approach would be for a firm to conduct each type of business through a separate entity. However, notwithstanding regulatory differences, there are business reasons and regulatory reasons[44] to consolidate all lines of a financial services business using a single capital base—and regulatory agencies generally are loathe to mandate business structures. This may mean, however, that to

[36] Section 4d(2) of the Commodity Exchange Act, 7 U.S.C. §6(d) and Commission rules 1.20, 17 C.F.R. §1.20 and 1.23, 17 C.F.R. §1.23.

[37] 48 *Fed. Reg.* 8716,8717 (March 1, 1983). *See also*, n.8 *supra*.

[38] "The ordering of priority claims follows 11 U.S.C. §507 generally, but, when the debtor is an FCM, 11 U.S.C. §766 supplements the priority ordering and gives the customers priority over all other unsecured claims except administrative costs:... Committee notes accompanying this statute emphasize that '[a] fundamental purpose of these provisions is to ensure that the property entrusted by customers to their brokers will not be subject to the risks of the broker's business and will be available for disbursement to customers if the broker becomes bankrupt.'" (citations omitted.) *In re Stotler and Co. (Oxford Organization, Ltd. v. Peterson)*, 144 Bank. Rep. 385, 386-7 and 392 (N.D. Ill. 1992).

[39] *See* 11 U.S.C. §105.

[40] 11 U.S.C. §101(31).

[41] *See* 11 U.S.C. §766(h) which, as of the 1982 amendments, reads: "Notwithstanding any other provisions of this subsection, a customer net equity claim based on a proprietary account, as defined by Commission rule, regulation or order, may not be paid either in whole or in part, directly or indirectly, out of customer property unless all other customer net equity claims have been paid in full"; and *compare* 11 U.S.C. §747.

[42] *See* 11 U.S.C. §548(a)(1).

[43] *See, e.g., In re Chicago Discount Commodity Brokers, Inc.* [1982-1984 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶22,084 (Bankr. N.D. Ill. 1984). *See, also, In re Volume Investors Corp.*, CFTC Docket No. 85-25 (1985) and n.21 *supra*.

[44] The CFTC capital rules assess capital charges on one side of the business—that is, the greater side. *See* Rule 1.17(a)(1)(i), 17 C.F.R. §1.17(a)(1)(i)

assure proper handling, the futures side of a joint estate should, in some way, be represented separately.

Conclusion

What does seem clear is that the ongoing discussions between the SEC, CFTC and SIPC (under the auspices of the MTAC) relative to developing mechanisms to address joint firm bankruptcies should seek to provide essential guidance to trustees in handling the complex matter of disposition of a joint estate. Hopefully, these discussions will be directed to facilitating the movement of customers out of a "fully segregated" debtor firm—because a firm with no futures customer accounts would not be a "commodity broker" and thus its bankruptcy would present no occasion for conflict with securities law. Movement of solvent customers' accounts to other firms also assures a continuing flow of payments to the market, notwithstanding the insolvency of the debtor, thus protecting the clearing system overall. If, as the law would permit, prior to bankruptcy securities customer accounts could be moved as well as futures accounts, an added benefit is the potential to reorganize the debtor firm rather than to liquidate it, which may have market benefits as well.[45]

For these reasons and in view of the obvious desirability of avoiding the dislocations caused by bankruptcy, the aforesaid discussions should be careful to preserve the existing incentives and historically tried and true transfer mechanisms for managing firm financial distress prior to insolvency and moving customer accounts prior to bankruptcy.[46] It would be a misfortune, indeed, if the systems which have worked so well, even under the most inclement of market situations, were weakened by an inability to use effectively the expertise of both disciplines and the tools of both protective schemes to provide maximum coverage to customers and the marketplace. ☐

[45] 11 U.S.C. §109(d) provides that "commodity brokers" and "stock brokers" may not take advantage of the reorganization provisions of Chapter 11. *See also* n.7, *supra*.

[46] Perhaps there should be enhanced authority to promptly move securities accounts after imposition of a stay under SIPA.

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Andrea S. Kramer and Phoebe A. Mix have joined McDermott, Will & Emery as partner and counsel respectively.

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