

MF Global Update: MF Global Proceedings Test Multiple Insolvency Statutes

November 15, 2011

On October 31, the MF Global enterprise collapsed into bankruptcy and a number of related insolvency proceedings. Amid allegations of improper commingling of customer accounts and rumors of misbegotten proprietary Eurobond trades, two unregulated entities – MF Global Finance USA Inc. and MF Global Holdings Ltd. (the Unregulated Debtors) – filed voluntary bankruptcy petitions on October 31, 2011. Later the same day, the Securities Investor Protection Corporation filed a complaint in the U.S. District Court for the Southern District of New York, seeking appointment of a trustee to commence liquidation of MF Global Inc. (MFGI) under the Securities Investor Protection Act (SIPA). By the end of the week, regulated brokerages were also in administration under local insolvency regimes in the United Kingdom, Australia, Singapore, India, Hong Kong and Canada.



The multi-layered proceedings will surely complicate the liquidation of the enterprise. For one thing, although the Unregulated Debtors may ultimately achieve some value from their equity or other interests in the regulated brokerages, it may be some time before they can monetize those interests. It is therefore unclear exactly how the Unregulated Debtors will survive in the meantime, with no meaningful cash flow of their own.

More important, multiple layers of insolvency regimes exist even within the single SIPA proceeding. Because MFGI was dually registered both as a securities broker-dealer and a futures commission merchant (FCM), at least two specialized insolvency laws apply. SIPA provides the framework for the liquidation of a broker-dealer. SIPA also applies the Bankruptcy Code, to the extent that it is not inconsistent with SIPA provisions. Therefore, Subchapter IV of Chapter 7 of the Bankruptcy Code – which governs the liquidation of FCMs – will also apply.

When the financial straits of MFGI became clear, the Securities and Exchange Commission and the Commodity Futures Trading Commission (CFTC) reportedly discussed the best way to liquidate the entity. They decided on the appointment of a trustee under SIPA, with the understanding that the SIPA trustee will also need to apply the commodity broker laws of the Bankruptcy Code. It remains to be seen how well a trustee appointed under the SIPA regime – presumably with a background primarily in securities laws – will be able to implement the commodity broker provisions of the Bankruptcy Code.

Alleged Mishandling of Customer Funds

Adding more complications are reports that MFGI mishandled customer funds. The Commodity Exchange Act (CEA) and CFTC regulations promulgated thereunder require that FCMs segregate customer funds from proprietary funds. Among other things, this arrangement is intended to facilitate the transfer of customer positions in the event of an FCM's bankruptcy. Segregation of customer collateral is

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considered to be “at the core of customer protection in the commodity futures and options markets.”¹ On the date of MFGI’s collapse, it was disclosed that more than \$600 million in customer funds, which were supposed to be segregated from MFGI’s assets, were unaccounted for. Various theories have been suggested about the missing customer funds. Some news reports suggest that MFGI used the customer funds to meet margin calls for its proprietary trades; others suggest that the missing funds reflect losses in investments made by MFGI with customer funds.² The CFTC and the SIPA trustee have launched an investigation into the whereabouts of the missing funds. As of the date of this Legal Alert, an estimated completion date for the investigation is not available because of the manner in which MFGI’s books and records were maintained. According to CFTC Commissioner Scott D. O’Malia, MFGI’s books and records are “a disaster,” an assessment echoed by several other market participants familiar with the MFGI situation.

The transfer of open MFGI customer positions to other FCMs was substantially completed as of November 10, 2011 but, due to the missing \$600 million in customer funds, the U.S. District Court for the Southern District of New York only authorized the transfer of sixty percent of the collateral posted in connection with such positions. Forty percent of the collateral posted in connection with such positions, as well as customer collateral not associated with open positions (*i.e.*, cash balances remaining at MFGI not tied to open positions because customers maintained excess collateral at MFGI or liquidated their open positions) remains frozen at exchanges and MFGI, respectively.

The SIPA trustee has indicated that a claims process will be instituted for customers to recover their frozen funds but the process may be lengthy. Certain MFGI customers filed a motion with the U.S. District Court for the Southern District of New York calling for the immediate release of customer cash balances that are frozen at MFGI.³ The SIPA trustee is expected to file a response to the motion later today, and a hearing on the motion is scheduled for November 22. Until such cash balances are unfrozen, customers’ existing losses will be further exacerbated by time-value-of-money issues.



Any customers of MFGI or creditors of the Unregulated Debtors should be following the bankruptcy proceedings closely. Not long ago, the MF Global enterprise appeared to be reasonably healthy, but its fortunes changed quickly. The same can happen in the context of the insolvency proceedings. It now appears likely that the universe of assets available for distribution will be less than expected.

¹ Press Release, CFTC Commissioner Jill E. Sommers to Act as Senior Commissioner for the Agency in Any Matters Relating to the Bankruptcy of MF Global, Inc. (Nov. 10, 2011) (available at www.cftc.gov/PressRoom/PressReleases/pr6140-11.)

² CFTC regulations permit the investment of customer funds in certain types of highly liquid assets and indicate that an FCM may receive and retain any increment or interest resulting therefrom. CFTC regulations are silent on how losses on such investments are apportioned, however. While it appears to be market practice that such losses would be borne by the FCM, no such requirement exists and, absent an agreement between the FCM and its customers to the contrary, such losses could, in theory, be borne by an FCM’s customers. See CFTC Regulations 1.25 and 1.29, 17 C.F.R. §§ 1.25, 1.29. See also Ronald H. Filler, *Are Customer Segregated/Secured Amount Funds Properly Protected After Lehman?* FUTURES & DERIVATIVES LAW REPORT, Volume 28, Issue 10 (Nov. 2008).

³ Motion of Movants Thomas A. Butler, Jr., James H. Barton, Jr., Stuart Satullo and Adam Loos for an Order Permitting Movants to Withdraw, or Transfer to Another Registered Futures Commission Merchant, a Portion of the Cash in their Segregated Customer Accounts at MF Global Inc., *In re: MF Global Inc.*, No. 11-2790 (Bankr. S.D.N.Y. Nov. 8, 2011).

Counterparties should monitor those cases to ensure that they do not bear an inordinate proportion of that shortfall. To do so, counterparties may visit the SIPA trustee's website, www.mfglobalTrustee.com, for additional information and periodic updates. Obviously, developments in this matter will also be of keen interest to those market participants following the CFTC's proposed treatment of customer collateral posted in connection with cleared swaps pursuant to the Dodd-Frank Wall Street Reform and Consumer Protection Act.

We will continue to monitor the MF Global situation and will update you on key events.



If you have any questions about this Legal Alert, please feel free to contact any of the attorneys listed below or the Sutherland attorney with whom you regularly work.

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