

## **Implications of MF Global Inc. SIPC Proceeding for Counterparties and Market Participants**

**November 1, 2011**

On October 31, the Securities Investor Protection Corporation (SIPC) filed for a protective order under the Securities Investor Protection Act (SIPA) for MF Global Inc., a company registered jointly as an Securities and Exchange Commission (SEC) registered broker and Commodity Futures Trading Commission (CFTC) registered futures commission merchant (FCM). James W. Giddens, the SIPC trustee for Lehman Brothers Inc. (LBI), was named SIPC trustee for MF Global Inc. and on November 1, 2011, Judge James M. Peck, the bankruptcy judge for the LBI SIPC proceeding, was assigned to the case. This follows the Chapter 11 bankruptcy filings of its affiliates, MF Global Holdings Ltd. and MF Global Finance USA Inc. In response to these filings, a number of clearinghouses have announced that they have suspended MF Global Inc.'s membership and have limited the types of trades that they will clear, including MF Global Inc. customer accounts. As described below, the insolvency of MF Global Inc. will have substantial consequences for commodities customers, investment advisers, counterparties in trades involving to-be-announced securities (TBAs), mutual funds, and introducing brokers. We briefly discuss these consequences and suggest next steps for affected market participants below.

### **Commodities Customers**

Parties with commodities accounts held at MF Global Inc., including futures and options positions, should be aware of the commodities insolvency regime and the handling of commodities accounts. The commodities insolvency regime is dependent on an FCM maintaining sufficient assets in accounts segregated for customer property to cover all of its customer obligations. Assuming that the FCM properly calculated the amount of assets that it needed to maintain in the segregated accounts, the accounts generally would be transferred to a solvent FCM. In the case of MF Global Inc., however, it has been reported in the *New York Times* that MF Global Inc. may have approximately \$700 million less than the required amount in accounts segregated for customer property (<http://dealbook.nytimes.com/2011/10/31/regulators-investigating-mf-global/>). If MF Global Inc. did not segregate sufficient assets to cover its customer obligations, any proprietary assets of MF Global Inc. will be used to make up the shortfall. However, if the proprietary assets are insufficient to cover the shortfall in segregated customer property, customers may suffer a pro rata loss as a result of the shortfall.

In terms of trading, the Chicago Mercantile Exchange and ICE Futures U.S. have each suspended MF Global Inc. as a member and have limited trades of customers of MF Global Inc. to liquidations.

### **Investment Advisers**

Investment advisers with clients that have possible custody or trading exposure to MF Global Inc. should quickly seek to evaluate the nature and extent of any such exposure and, depending on the circumstances,

inform clients regarding the insolvency proceeding. As a first step, investment advisers should review their custody arrangements and trading records to determine if any of their clients have assets held at or outstanding transactions with MF Global Inc. If an investment adviser determines that its clients have exposure to MF Global Inc., the investment adviser should consider sending notices to its clients informing them of the insolvency filing, the amount and source of the client's exposure to MF Global Inc., and the potential next steps. They should advise clients that these next steps may include the filing of claims in the SIPC proceeding once the trustee has announced the claims filing process and deadlines. In addition, clients should be advised to find out whether they have assets or transactions with MF Global Inc. through other investment advisers so that they may exercise any netting rights that they may have under a contract or common law.

## **TBA Counterparties**

TBA counterparties with open TBA trades with MF Global Inc. will have their trades liquidated and, depending on how TBA trades are classified (customer or general unsecured), may be left with a minimal recovery on any money owed to them. The Fixed Income Clearing Corporation (FICC) has announced that it is liquidating all TBA trades involving MF Global Inc. that are due to settle after November 1, 2011 and that counterparties to MF Global Inc. are not to take any actions regarding the trades. For open TBA trades with a settlement date of November 1, 2011 or prior, the FICC is requiring the participants to liquidate the trades on a net basis, but requiring that the netting be performed separately for each MF Global account. For additional details, please see the FICC notice at [http://www.dtcc.com/downloads/legal/imp\\_notices/2011/ficc/mbs/MBS173.11.pdf](http://www.dtcc.com/downloads/legal/imp_notices/2011/ficc/mbs/MBS173.11.pdf).

TBA counterparties that are owed money by MF Global Inc. will be required to file claims in the SIPC proceeding for MF Global Inc. Whether these claims will be granted priority status as a customer claim in the SIPC proceeding may be impacted by the LBI SIPC proceeding. In the LBI proceeding, the SIPC trustee has challenged whether TBA counterparties are entitled to customer status. The issue has been briefed to the court and a hearing date has been set for November 17, 2011. If the TBA counterparties are not granted customer status, those claims will likely be classified as general creditor claims. As general creditor claims are paid after all customer claims have been satisfied, there may be a minimal recovery for these types of claims.

## **Mutual Funds**

Mutual funds may also have exposure to MF Global Inc. because they entered into short sales through MF Global Inc. or posted collateral to MF Global Inc. in connection with commodity positions carried there or options they wrote carried through MF Global Inc. Mutual funds that were involved in such trades with MF Global Inc. should review their tri-party pledge agreements with the custodian and MF Global Inc. to determine if the collateral is under their own control. According to the court in the LBI SIPC proceeding, if the insolvent broker-dealer is the only party entitled to give instructions to the custodian regarding the handling of the collateral, the collateral is customer property under SIPA and the claimant may only recover its pro rata share of its claim through the SIPA process. For a copy of this decision, see [http://www.lehmancreditors.com/Lehman/LehmanCC.nsf/AllWebEditSelect/171C83A96D4F3B25852577350062DB62/\\$File/3330-Decision\\_re\\_fifth\\_third.pdf?OpenElement](http://www.lehmancreditors.com/Lehman/LehmanCC.nsf/AllWebEditSelect/171C83A96D4F3B25852577350062DB62/$File/3330-Decision_re_fifth_third.pdf?OpenElement).

## **Introducing Brokers**

Introducing brokers to MF Global Inc. may have difficulty recovering amounts owed to them for commissions or clearing deposits, but should be able to obtain customer status for their proprietary trading accounts. In particular, claims for commissions owed by a clearing broker are generally treated as general

creditor claims and therefore do not receive priority status in a SIPC proceeding or under the commodities laws. Although clearing deposits for securities accounts are generally treated as general creditor claims, introducing brokers may be able to argue that their claims are customer claims if they elected to have their clearing deposit segregated for purposes of the net capital rule under the guidance for Proprietary Accounts of Introducing Brokers (PAIB Accounts). However, PAIB Accounts are not contemplated under the commodities regulatory regime, so it is unclear what arguments can be made for customer treatment of commodity clearing accounts. Proprietary trading accounts should be accorded customer status under both the securities and commodities rules.

## **Additional Guidance**

Morgan Lewis will continue to monitor the MF Global Inc. proceeding and is well positioned to help investment advisers, TBA counterparties, mutual funds, commodities counterparties, and introducing brokers determine the implications of the MF Global SIPC filing to their businesses.

If you would like more information or have any questions about the issues discussed in this LawFlash, please contact any of the following Morgan Lewis attorneys:

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