U.S. COMMODITY FUTURES TRADING COMMISSION

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UNITED STATES BANKRUPTCY COURT
SOUTHERN DISTRICT OF NEW YORK

In re: MF GLOBAL Inc., Debtor.	Case No. 11-2790 (MG) SIPA
KOCH SUPPLY & TRADING, LP, Plaintiff, v. JAMES W. GIDDENS, Trustee for the SIPA Liquidation of MF Global Inc., Defendant.	Adv. Pro. No. 12-01754 (MG)

BRIEF OF THE COMMODITY FUTURES TRADING COMMISSION IN SUPPORT OF THE TRUSTEE'S MOTION FOR SUMMARY JUDGMENT

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The U.S. Commodity Futures Trading Commission ("CFTC" or the "Commission") respectfully submits this Memorandum of Law, pursuant to 11 U.S.C. § 762(b), to assist the Court in resolving the parties' cross-motions for summary judgment in the above-captioned adversary proceeding between Koch Supply & Trading, LP ("KS&T") and James W. Giddens, liquidation trustee for MF Global, Inc. ("Trustee"). As explained below, KS&T misinterprets CFTC Regulation 190.08(a)(1)(i)(E), concerning the treatment of letters of credit as customer property in a commodity broker liquidation. Thus, to the extent the cross-motions turn upon that provision, the Trustee is entitled to judgment as a matter of law.

INTRODUCTION

CFTC regulations permit a futures trader to use a letter of credit, in place of cash, to collateralize (or "margin") a futures transaction. In 1983, however, the Commission identified and addressed a problem associated with that practice – that in the event of a broker bankruptcy and shortfall in customer property, customers that posted cash or securities as margin would suffer a disproportionate share of the loss. That is because the Bankruptcy Code requires a liquidation trustee to distribute customer property on a pro rata basis. Unless a letter of credit is replaced in bankruptcy with an equivalent sum of cash, the pool of assets to be divided among injured customers would be reduced, dollar for dollar, by the face value of the letter, while letter-of-credit customers would avoid the loss. This would be a strong additional incentive, for those traders who are able, to use letters of credit in lieu of cash or securities. Generally, this would include only larger traders, and it would come at the expense of smaller market participants. The Commission determined that this might be destabilizing to markets, as well as unfair to other customers in a shortfall, and that it would be contrary to the intent of the Bankruptcy Code.

Armed with a Congressional directive under the Bankruptcy Reform Act of 1978 to regulate commodity broker bankruptcies and to decide what assets should be "customer property" subject to pro rata distribution, the Commission established a market regulation to foreclose the harmful result it had identified: CFTC Rule 190.08(a)(1)(i)(E) states that if a trader elects to use a letter of credit to margin futures transactions, it does so on the condition that, in bankruptcy, the liquidation trustee is entitled to collect the "full proceeds" of that letter – that is, to replace, dollar for dollar, the cash for which the letter of credit has served as a substitute in the customer's account.

The dispute in this case focuses on the meaning of term "proceeds" in Rule 190.08(a)(1)(i)(E). The Trustee seeks to collect the full face value of KS&T's letter of credit; KS&T, however, argues that "proceeds" are limited to those funds that the Trustee may collect "from the issuing bank" following "a presentation that complied will all of the Letter of Credit's terms and conditions," including a written certification, prior to December 31, 2011, that KS&T was in default. (ECF Doc. No. 36-1 at 14, 17.) As explained below, KS&T's definition is incorrect and would frustrate the above-described purposes of the rule. Indeed, payments the Trustee receives to cure a customer's default typically are *not* customer property. In the rulemaking process that led to Rule 190.08(a)(1)(i)(E), the CFTC considered and rejected suggestions from commenters to amend the rule along the lines that KS&T suggests here. For the policy reasons described above, the Commission concluded that a liquidation trustee must collect the "full value" of such letters "irrespective of their terms even though they generally condition payment on delivery of a certification" of default. *Bankruptcy*, 48 Fed. Reg. 8716, 8718 (Mar. 1, 1983).

Finally, in a footnote, KS&T suggests that Rule 190.08(a)(1)(i)(E) may exceed the Commission's delegated authority. (ECF Doc. No. 36-1 at 15 of 26 n.14.) If KS&T pursues this argument, the Commission reserves the right to respond in full. For present purposes, however, the Commission below explains the legal basis for Rule 190.08(a)(1)(i)(E), which is squarely within the CFTC's authority to regulate transactions involving futures and to establish the rules for liquidating a commodity broker.

The Commission, therefore, supports the Trustee's motion for summary judgment.

REGULATORY BACKGROUND

1. Under the Commodity Exchange Act ("CEA"), the CFTC has "exclusive jurisdiction" to regulate, *inter alia*, "transactions involving" commodity futures. 7 U.S.C. § 2(a)(1)(A). Within that exclusive jurisdiction, Congress has delegated to the CFTC plenary power "to make or promulgate such rules and regulations as, in the judgment of the Commission, are reasonably necessary to effectuate any of the provisions or to accomplish any of the purposes of the" CEA. *Id*. § 12a(5). Those purposes include protecting "the financial integrity of all transactions subject to" the CEA, "the avoidance of systemic risk," and the protection of "all market participants from . . . misuses of customer assets." *Id*. § 5(b). The CEA also charges the Commission with comprehensive regulation of commodity brokers including futures commission merchants ("FCMs") like MF Global, Inc., *see, e.g.*, 7 U.S.C. §§ 6d(a), 6f(a)-(b), and it grants the CFTC broad authority to regulate the use of margin to collateralize futures transactions. *See id*. § 12a(7)(D) (empowering the CFTC to set "margin requirements" to protect the financial integrity of clearing organizations); *id*. § 12a(5) (plenary rulemaking authority).

The CEA and the CFTC's regulations currently permit a broad range of property to be used as margin. *See, e.g.*, *id*. § 6d(a)(1) (referring to "money, securities, and property" to be used as margin); 17 C.F.R. § 190.08(a)(i) ("All cash, securities, or other property"). Although the Commission has expressed reservations about the use of letters of credit for this purpose, 48 Fed. Reg. at 8718-19 (stating that "it would be unwise to adopt a policy which would further encourage the use of letters of credit" in this way), some market participants find the practice useful, and there currently is no prohibition in the context of futures transactions. *But see* 17 C.F.R. § 39.13(g)(10) (stating that a clearinghouse "shall not accept letters of credit as initial margin for swaps").

2. Soon after enacting the modern CEA, Congress recognized the existence of "unique problems raised by commodity broker bankruptcies." S. Rep. 95-989 (1978), *reprinted in* 1978 U.S.C.C.A.N. 5787, 5793. In response, Congress established Bankruptcy Code Subchapter IV of Chapter 7, 11 U.S.C. §§ 761-67, in the Bankruptcy Reform Act of 1978, applicable only to commodity broker liquidations, with "customer protection as a primary objective." S. Rep. 95-989, 1978 U.S.C.C.A.N. at 5794. The linchpin of Subchapter IV in that respect is Section 766(h), which requires a liquidation trustee to distribute all "customer property" to customers "ratably" and in priority to other claims. 11 U.S.C. § 766(h). The statute defines "customer property" to include all "property, or the proceeds of such . . . property, received, acquired, or held by or for the account of the debtor, from or for the account of a customer," including such property "held to margin" a commodity contract. *Id*. § 761(10). Thus, all property that the debtor has received from a customer to margin a commodity contract, and all proceeds derived from that property, are subject to pro rata distribution.

3. While Congress established this "framework," it declined to legislate "detailed rules to govern every contingency" in a broker liquidation. S. Rep. 95-989, at 8 (1978), *reprinted in* 1978 U.S.C.C.A.N. 5787. Instead, it delegated "general rulemaking authority" to the CFTC. *Id*. Among the powers delegated, Congress charged the Commission with establishing the "method by which the business of [a] commodity broker is to be . . . liquidated" and with determining what constitutes "customer property" to be distributed pro rata. 7 U.S.C. § 24(a). Pursuant to these powers, as well as the Commission's plenary power under 7 U.S.C. § 12a(5) to regulate

transactions involving futures, the CFTC in 1983 enacted the "Part 190 Rules," 17 C.F.R. §§ 190.01 *et seq*., to govern the liquidation of a commodity broker, the calculation of allowed claims, and the marshaling and distribution of assets to customers. *See* 48 Fed. Reg. at 8739. As relevant here, Rule 190.02(f) directs the trustee to "liquidate" all "property held by or for the account of" the debtor. 17 C.F.R. § 190.02(f). If that property includes a letter of credit that the FCM holds as margin, Rule 190.08(a)(1)(i)(E) states that the "full proceeds" of that letter become "customer property" to be distributed pro rata. *Id*. § 190.08(a)(1)(i)(E).

4. The Commission adopted these rules pursuant to a formal notice and comment process under the Administrative Procedures Act. *See* 5 U.S.C. § 553. The Commission proposed Part 190 in 1981, along with detailed interpretations and explanations of how the rules would operate in practice. *See Bankruptcy*, 46 Fed. Reg. 57535 (proposed Nov. 24, 1981). In the proposal, the Commission "singled out" letters of credit, specifying that, if a customer chose to use such an instrument to margin trades, it did so on the condition that, in the event of the FCM's bankruptcy, the trustee would be entitled to the "full value" of the letter, which would become customer property, subject to pro rata distribution:

> Letters of credit are singled out for special treatment because the Commission believes that it is important to make clear that the *full value* of a letter of credit posted as margin would be drawn in the event of a bankruptcy and the full proceeds thereof would be treated as customer property.

Id. at 57553 (emphasis added).

A six-month comment period followed. 48 Fed. Reg. at 8716. The Commission received several submissions, including three from commenters who focused on the letter-of-credit issue and argued that the rule "should be amended" to restrict the trustee from collecting such proceeds *except* as provided by the terms of the letter, such as to cover a default. Ltr. from FIA to CFTC (May 12, 1982) at 40-41 (Schwartz Decl. Ex. A) (stating that the rule "should be amended" so that "letters of credit may be drawn by a trustee only to meet a broker's or customer's margin requirement"); Ltr. from Chicago Bd. of Trade to J. Stuckey, Secretariat, CFTC (May 14, 1982) at 10-11 (Schwartz Decl. Ex. B) (similar); Ltr. from E. Schroeder to J. Stuckey (May 15, 1982) at 38-39 ("ABA Ltr.") (Schwartz Decl. Ex. C) (similar). The ABA Committee on Commodities Regulation, for example, noted that letters of credit "frequently contain" such "terms conditioning payment on delivery of a certification that additional funds are required to margin a contract or to cover a default," but the proposed rule would "require a trustee to draw the full proceeds of a letter of credit *irrespective of [those] terms*." ABA Ltr. at 38-39 (emphasis added).

5. The Commission considered the commenters' suggestions, consulted with market participants and the trustee in a liquidation, and voted unanimously to adopt the rule as proposed. *See* CFTC Minutes (Feb. 15, 1983) at 1 (Schwartz Decl. Ex. D); 48 Fed. Reg. at 8718, 8738. Throughout the release, the Commission explained that its objective was to implement Congress' design of equitable, pro rata distribution, and to do so in a manner that would protect small customers from unfair disadvantage. 48 Fed. Reg. at 8719 (noting that the Code was "intended to assure parity between customers with margining power and those without it"); *id*. ("[T]he Code itself . . . contains no provisions for the reclamation of property free of a pro rata distribution"); *id*. at 8724 (rejecting a suggestion that "would undermine the basic concept of a bankruptcy proceeding which is intended to ensure that no one obtains more than his pro rata share"). The Commission agreed that the rule would empower the trustee to demand payment "irrespective" of letter terms conditioning "payment on delivery of a certification" of default. *Id*. at 8718. But, the Commission explained, this condition on the use of letters of credit in futures transactions is necessary to protect other customers from injury in the form of diminished pro

rata shares, and that a contrary rule would catalyze additional use of letters of credit, exacerbating the problem:

> The Commission's proposal was intended to assure that customers using a letter of credit to meet original margin obligations would be treated no differently than customers depositing other forms of non-cash margin or customers with excess cash margin deposits. If letters of credit are treated differently than Treasury bills or other non-cash deposits, there would be a substantial incentive to use and accept such letters of credit as margin as they would be a means of avoiding the pro rata distribution of margin funds, contrary to the intent of the Code.

Id. at 8718. In response to the commenters, the Commission explained that their suggested approach "would favor large customers at the expense of smaller market participants since only larger customers are permitted to make non-cash deposits of margin." *Id*. at 8719. For every large customer permitted to exclude its margin amount from customer property, the universe of assets to be distributed pro rata would be diminished. The Commission concluded that this would be contrary to the intent of Subchapter IV and "inherently unfair." *Id*.

The Commission also was "guided by additional policy considerations" related to market stability. It expressed concern about the "viability" of letters of credit as margin deposits, because they are relatively cumbersome to convert to cash in response to a market event. *Id.*; *see also id.* at 8718 n.14 (noting clearing organizations' policy changes in response to "periods of volatility"). It would therefore be "unwise," the Commission explained, "to adopt a policy which would further encourage the use of letters of credit and, indeed, their substitution for other forms of margin." *Id.* at 8719. Accordingly, the Commission resolved that if a customer does choose to margin using a letter of credit, it may do so only on the condition that, in the event of bankruptcy, the trustee would be entitled to the full face amount of the letter. *Id*. at 8718.

STANDARD OF REVIEW

An agency's interpretation of its own regulation is "controlling" unless "plainly erroneous or inconsistent with the regulation" itself. *Auer v. Robbins*, 519 U.S. 452, 461 (1997) (internal quotation marks omitted). Deference is "even more clearly in order" when the agency offers a "contemporaneous construction" of its own regulation at enactment, *Udall v. Tallman*, 380 U.S. 1, 16 (1965) (internal quotation marks omitted), and courts must "normally accord particular deference to an agency interpretation of 'longstanding' duration," *Barnhart v. Walton*, 535 U.S. 212, 220 (2002). The highest deference is required where, as here, the interpretation was subject to notice and comment and, therefore, can "create no unfair surprise." *Long Island Care at Home, Ltd. v. Coke*, 551 U.S. 158, 170-71 (2007); *United States v. Mead Corp.*, 533 U.S. 218, 226-27 (2001). Nevertheless, controlling deference is due "even if th[e] interpretation appears in a legal brief." *Union Carbide Corp. v. Comm'r of Internal Revenue*, _ F.3d_, No. 11-2552, 2012 U.S. App. LEXIS 18876, at *11-12 (2d Cir. Sept. 7, 2012); *see also Talk Am., Inc. v. Mich. Bell Tel. Co.*, 131 S. Ct. 2254, 2261 (2011); *Auer*, 519 U.S. at 461.[1]

DISCUSSION

I. The Full Face Value of the Letter of Credit Is Customer Property.

The Part 190 Rules require the trustee to "liquidate" all "property held by" the debtor and, if that property includes a customer's letter of credit, the "full proceeds" of the letter

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[1] To the extent KS&T disputes the CFTC's authority with respect to Rule 190.08(a)(1)(i)(E), the Commission is entitled to deference under *Chevron, U.S.A., Inc. v. NRDC, Inc.*, 467 U.S. 837, 843-44 (1984). Where, as here, an agency acts pursuant to "an express delegation of authority," the resulting "legislative regulations are given controlling weight unless they are arbitrary, capricious, or manifestly contrary to the statute." *Id*. The Court must affirm the agency's action so long as it "is rational, based on consideration of the relevant factors, and within the scope of the authority delegated." *Motor Vehicle Mfrs. Ass'n v. State Farm Mut. Auto. Ins. Co.*, 463 U.S. 29, 42 (1983). With respect to the Commission's interpretation of the delegations in the CEA, the first question under *Chevron* is "whether Congress has directly spoken to the precise question at issue." 467 U.S. at 842-843. If Congress has not "unambiguously expressed" a "clear" intent on the issue, the question is "whether the agency's answer is based on a permissible construction of the statute." *Id*. In that inquiry, "the court does not simply impose its own construction" of the statute. *Id.* Rather, it must accept "any reasonable interpretation" by the agency. *Wong v. Holder*, 633 F.3d 64, 74 (2d Cir. 2011). This standard is "highly deferential." *NRA of Am., Inc. v. Reno*, 216 F.3d 122, 137 (D.C. Cir. 2000). The Supreme Court has cautioned that, in particular, the CFTC's "expertise is superior to that of a court when," as here, "a dispute centers on whether a particular regulation is 'reasonably necessary to effectuate any of the provisions or to accomplish any of the purposes'" of the CEA; "the agency's position, in such circumstances, is therefore due substantial deference." *CFTC v. Schor*, 478 U.S. 833, 845 (1986).

become "customer property" subject to pro rata distribution. 17 C.F.R. §§ 190.02(f), 190.08(a)(1)(i)(E). These terms do not, as KS&T argues, limit the Trustee to funds he can obtain by presenting the letter to a bank accompanied by a certification of default – that approach was considered and rejected in the Part 190 rulemaking process. Instead, the Trustee is entitled to the full face value of the letter, irrespective of conditions that may apply outside of bankruptcy.

1. To "liquidate," as used in Part 190, means to "convert (a nonliquid asset) into cash" or "[t]o settle (an obligation) by payment or other adjustment." *Twp. of Spring v. Std. Ins. Co.*, No. 09-5518, 2011 U.S. Dist. LEXIS 59241, at *16 (E.D. Pa. June 1, 2011) (quoting Black's Law Dictionary 1014 (9th ed. 2009)); *Lumber Liquidators, Inc. v. Stone Mt. Carpet Mills, Inc.*, No. 3:08-cv-573, 2009 U.S. Dist. LEXIS 59388, *21-22 (E.D. Va. July 10, 2009) (stating that "'liquidate' can be defined broadly . . . to mean 'to convert assets to cash'" (quoting Webster's New Collegiate Dictionary 697 (9th ed. 1987)). The term "proceeds" has its usual meaning: "something that results or accrues; the total amount derived from a sale or other transaction." *Random House Unabridged Dictionary* 1542 (2d ed. 1993). Thus, when an FCM goes into bankruptcy, the trustee is directed to draw down or otherwise settle with the customer, thereby converting to cash, any letters of credit the FCM is holding in a customer account. *See* 46 Fed. Reg. at 57553; 48 Fed. Reg. at 8718.

2. KS&T cites UCC Section 5-114(a) for the proposition that "proceeds" are limited to "the funds that the beneficiary receives from the issuing bank when it draws on the letter." (ECF Doc. No. 36-1 at 14 of 26.) But the CFTC did not adopt that definition in Part 190. Rather, "proceeds" is used throughout Part 190 in the broader sense noted above – the total amount derived from a transaction. *See* 17 C.F.R. §§ 190.04(e)(3), 190.05(a)(3), 190.07(b)(1)(iii)(A)(2), (B)(3), & (e)(1), (4)-(5). The Commission intended this term to have the same meaning

throughout Part 190, which is the presumption when an agency uses identical language in different parts of related regulations. *Arnett v. Comm'r*, 473 F.3d 790, 798 (7th Cir. 2007); *Transactive Corp. v. United States*, 91 F.3d 232, 238 (D.C. Cir. 1996); *Reich v. Gateway Press*, 13 F.3d 685, 700 n.19 (3d Cir. 1994) (Becker, Nygaard, Alito, JJ.). This is also consistent with Subchapter IV, which likewise uses the term "proceeds" in the broad sense applicable to any form of property that the trustee must convert to cash. 11 U.S.C. § 761(10).

3. Indeed, KS&T's interpretation restricting customer property to funds received following a certification of default is not plausible because such proceeds would generally *not* be susceptible to treatment as customer property. Instead, they would be owed as margin payments to cover trading losses already incurred. As the CFTC explained in the adopting release, "the standby feature of the letter [of credit] only guarantees the payment of variation margin," 48 Fed. Reg. at 8718, and such "margin payments would not be able to be distributed pro rata because, as in ordinary practice, they would be credited directly for the account to which they were made." 46 Fed. Reg. at 57542; *see also* 48 Fed. Reg. at 8727. In other words, if there is a margin call and the customer defaults, the funds received cannot be distributed pro rata, because they are owed to the clearinghouse to cover losses.

4. KS&T repeatedly quotes the Commission's use of the word "draw" in the rule release as proof that Rule 190.08(a)(1)(i)(E) limits the Trustee to cash he can obtain from the issuing bank under the terms of the letter. (ECF Doc. No. 36-1 at 7, 14, 16, 22 of 26 (quoting 48 Fed. Reg. at 8718).) But this language is excerpted misleadingly from a sentence addressing a different issue – whether the trustee is entitled to the "full value" or only "the margin obligation secured" by the letter:

> Under this approach, the trustee *would be required to draw the full value* of a letter of credit posted as margin and treat the funds received as customer property, *irrespective of the margin obligation secured thereby*. The Commission's proposal recognizes that it is the letter of credit itself which is posted as original margin, and the standby feature of the letter only guarantees the payment of variation margin.

48 Fed. Reg. at 8718 (emphases added).[2] The Commission was not expressing a preference for cash from one source or another. Such a distinction, urged by KS&T, would be arbitrary, as the source of the cash makes no difference either in terms of estate administration or to the letter-of-credit customer, who is liable for the full amount, whether payment is owed to the issuing bank or given directly to the Trustee. On the other hand, the limitation KS&T reads into the rule would conflict with the rest of the Commission's interpretation, which makes clear that letter-of-credit customers are to share in any shortfall just as though they had posted cash, and in which the Commission stressed the overriding objective of preventing injury to other customers. *Id*. (stating that letter of credit customers "would be treated no differently" than cash customers).

There are many factual scenarios in which a trustee might be unable to obtain cash from the issuing bank, or might validly choose to proceed in some other way, none of which would justify inequitable distribution of the bankruptcy loss. For example, the letter-of-credit customer may intercede to block payment through legal process or other means. In other cases, the trustee

[2] In other words, letter-of-credit customers will typically post a letter with a face value higher than their current margin obligation so as to cover fluctuations that might otherwise require additional deposits.

might decide, in the exercise of business judgment, that it would serve the estate's interests to negotiate directly with the customer. If the FCM bankruptcy occurs in the context of acute market turmoil, the issuing bank may be unable to pay. Or, as appears to be the case here, the letter of credit's expiration date may occur before the trustee of a large FCM in a complex liquidation is able to convert the instrument to cash.[3] None of those circumstances would be cause to shift more of the shortfall to customers using cash or securities to margin, and the language excerpted by KS&T does not approve that inequitable result. To the contrary, the Commission stated that letter of credit customers are to be "treated no differently" than if they had posted equivalent cash. 48 Fed. Reg. at 8718. Thus, "full proceeds" must be interpreted as the Trustee does here, to entitle the estate to the full face value.

II. There Is No Requirement that the Trustee Present a Certification of Default – Prior to the Expiration Date or at Any Other Time.

1. Under Rule 190.08(a)(1)(i)(E), the Trustee's right to the "full proceeds" of a letter of credit used to margin is not conditional on a default by the customer. Rather, the Trustee is to collect the "full proceeds" of the letter "irrespective of [its] terms." 48 Fed. Reg. at 8718. Contrary to KS&T's argument, therefore, there is no basis to require a trustee to make a certification of such default in accordance with the letter's terms, as would be required outside the context of Part 190. The trustee need not do so at *any* time – in fact, as KS&T explains, the trustee *should not* do so unless it is true (ECF Doc. No. 36-1 at 23 of 26 n.22) – much less is he required to make such certification in advance of a deadline pertaining to events of default that appears on the face of the instrument. This interpretation is required for consistency with the pro rata distribution system established in 11 U.S.C. § 766(h) and the Part 190 Rules, and it is

[3] The Commission does not have direct knowledge of these facts, and these scenarios are given by way of illustration and not intended as exhaustive. As the Commission interprets Rule 190.08(a)(1)(i)(E), the specifics underlying the Trustee's course of action in this respect are not material to the parties' cross-motions.

"controlling." *Auer*, 519 U.S. at 461 (holding that an agency's interpretation of its own regulation is "controlling unless plainly erroneous or inconsistent with the regulation").

2. The Commission adopted Rule 190.08(a)(1)(i)(E) to "assure that customers using a letter of credit to meet original margin obligations would be treated no differently than customers depositing other forms of non-cash margin or customers with excess cash margin deposit." *Id*. Indeed, "[t]he purpose of a letter of credit is to substitute for, and therefore support, an engagement to pay money." *First Commercial Bank v. Gotham Originals, Inc.*, 64 N.Y.2d 287, 294 (1985). Once the FCM is placed into bankruptcy, the trustee's right to that money, and any resulting obligations on the part of the customer, are fixed at the full face value of the letter. There is no textual or policy justification to enforce a time limit intended for events of default – to the contrary, the "expiration" of a trustee's right to those proceeds would cause the very injury that Rule 190.08(a)(1)(i)(E) is designed to prevent. The Commission, moreover, has stressed the need "to 'fix'" each customer's "bankruptcy loss at a particular point in time." 46 Fed. Reg. at 57547. Each of those purposes would be defeated if a letter-of-credit customer were to be treated differently based on the letter's expiration date.

3. The adopting release also states that the Part 190 Rules should not be interpreted to "require the trustee to engage in useless activities or to expend debtor funds needlessly." 48 Fed. Reg. at 8720. Here, KS&T argues that even *prior* to expiration, the Trustee was entitled to "$0." (ECF Doc. No. 36-1 at 23 of 26 n.22.) KS&T asserts that the Trustee could only have collected the face value of the letter by making "a presentation that complied with the Letter of Credit's terms and conditions," which he "could not" have done "without committing material fraud." (*Id*. at 17, 23 of 26 n.22.) Thus, on KS&T's own theory, it would have been futile and wasteful for the Trustee to make demand of the issuing bank. More generally, interpreting Rule

190.08(a)(1)(i)(E) to require immediate presentation of a letter of credit risks wasting estate assets in hurried litigation in any case where, as here, payment under the letter is contested. On the other hand, no purpose would be served by having the allocation of the limited estate assets among customers turn on whether the trustee makes demand before or after the deadline for certifying events of default, so long as the letter was valid and being used as a substitute for cash margin at the time of bankruptcy.

Finally, KS&T cites several cases for the proposition that, upon expiration of a contract, the debtor's rights cease to be enforceable. None of those cases, however, concern Rule 190.08(a)(1)(i)(E) or any instance of a debtor's vested, unconditional right to cash payment, as exists here in favor of the estate. *See Sullivan v. Willock*, 854 F.2d 196, 199 (7th Cir. 1988) (debtor "breached the contract" by failing to complete a real estate transaction and lost "his down payment and both his rights and liabilities under the contract"); *Durwick, LLC v. Doe*, No. 11-1723, 2012 WL 2946877, at *3 (D. Colo. Bankr. June 1, 2012) (under applicable law, debtor had "no further rights to redeem the Property"); *In re Edgewater Med. Ctr.*, 373 B.R. 845, 853 (N.D. Ill. Bankr. 2007) ("The termination of the right to perform on an executory contract . . . differs from a transfer of property . . . ." (internal quotation marks omitted)); *Coast Cities Truck Sales, Inc. v. Navistar Int'l Transp. Co.*, 147 B.R. 674, 677 (D.N.J. 1992) ("[E]xecutory contracts validly terminated prior to the commencement of bankruptcy proceedings are not resurrected[.]" (internal quotation marks omitted)). Here, the debtor here has no further performance obligations, and the Trustee simply is entitled to collect the full proceeds of the letter.

III. Rule 190.08(a)(1)(i)(E) Is a Lawful Exercise of the Commission's Exclusive Jurisdiction over Transactions Involving Futures.

KS&T states in a footnote that the rule, as interpreted above, would exceed the CFTC's authority. (ECF Doc. No. 36-1 at 15 of 26 at n.14.) This argument is waived, because it is not properly presented. *In re UBS AG ERISA Litig.*, No. 08 Civ. 6696, 2012 U.S. Dist. LEXIS 51806, at *9 (S.D.N.Y. Mar. 23, 2012) ("Arguments which appear in footnotes are generally deemed to have been waived."); *In re Crude Oil Commodity Litig.*, 06 Civ. 6677, 2007 U.S. Dist. LEXIS 66208, at *9 (S.D.N.Y. Sept. 7, 2007) (Buchwald, J.) (same). In any event, KS&T's interpretation of the CFTC's authority is without basis.

1. First, KS&T states that application of Rule 190.08(a)(1)(i)(E) would "alter property rights" in excess of the Commission's authority to include or exclude "property" from "customer property." (ECF Doc. No. 36-1 at 15 of 26 at n.14.) But KS&T's rights with respect to these transactions and assets have always been subject to and circumscribed by CFTC regulations, including the Part 190 Rules. KS&T accepted these conditions when it chose to participate in the CFTC's jurisdictional markets. *See Marshall v. Barlow's, Inc.*, 436 U.S. 307, 313 (1978) ("The businessman in a regulated industry in effect consents to the restrictions placed upon him."). KS&T's customer agreement states that "[a]ll transactions shall be subject to . . . the rules and regulations of all federal . . . agencies." (ECF Doc. No. 35-6, ¶ 2; *see also id.* ¶ 29.A ("This Agreement . . . shall be governed by . . . the laws of the United States.").) Even without that express incorporation of federal law, applicable CFTC regulations would govern, and the Part 190 Rules would apply of their own force. *Marshall*, 436 U.S. at 313; *Costello v. Grundon*, 651 F.3d 614, 640 (7th Cir. 2011) ("[U]nder Illinois law,[[4]] laws in existence at the time a contract is executed, are deemed, in the absence of contractual language to the contrary, part of the contract as though they were expressly incorporated therein." (internal quotation marks omitted)). "When parties enter into a contract, they are presumed to accept all the rights and obligations imposed on their relationship by state (or federal) law." *Resolution Trust Corp. v. Diamond*, 45 F.3d 665, 673 (2d Cir. 1995). Moreover, any state law (of property, contract, or

[4] KS&T's customer agreement states that it is governed by Illinois law. (ECF Doc. No. 35-6, ¶ 29.A.)

otherwise), that purported to contradict Rule 190.08(a)(1)(i)(E), would be preempted from applying here. 7 U.S.C. § 2(a)(1)(A); H.R. Rep. 93-1383 (1974) (Conf. Rep.), *reprinted in* 1974 U.S.C.C.A.N. 5894, 5897; *Leist v. Simplot*, 638 F.2d 283, 322 (2d Cir. 1980).

2. KS&T also cites 7 U.S.C. § 27a, which restricts the CFTC from "exercis[ing] regulatory authority" over letters of credit and certain other bank products. But that jurisdictional provision is not relevant here, because the rule does not purport to bring letters of credit within the Commission's "regulatory authority." Congress enacted Section 27a to confirm that identified banking products "will not be regulated *as futures contracts*." 146 Cong. Rec. S11918, 11925 (Dec. 15, 2000) (Sen. Lugar) (emphasis added). The provision, thus, "clarif[ies] the jurisdictional line between the regulation of banking products and futures products." 146 Cong. Rec. S11855, 11867 (Dec. 15, 2000) (Sen. Gramm); *see also* 146 Cong. Rec. E2181 (Dec. 14, 2000) (Rep. Ewing) ("Title IV, the 'Legal Certainty for Bank Products Act of 2000', excludes identified banking products from the Commodity Exchange Act. It provides guidelines to determine the proper regulator for hybrid products."). In the Dodd-Frank Act, Congress redrew this jurisdictional line to separate regulation of those banking products from the CFTC's new regulatory authority over "swaps." *See* Dodd-Frank Wall Street Reform & Consumer Protection Act, P.L. 111-203, § 725, 124 Stat. 1376, 1685 (July 21, 2010). As a result, the Commission may not, for example, bring an enforcement action charging a bank with a CFTC registration violation for issuing an ordinary letter of credit, *see* 17 C.F.R. § 3.10, and it may not, on the basis of such activity, require a bank to keep the books and records required of a swap dealer, *id*. § 23.201. In contrast to commodity market regulations of that nature, Rule 190.08(a)(1)(i)(E) does not apply to letters of credit *except* to place conditions on a trader's use of one in a futures transaction over which the CFTC has exclusive jurisdiction. *See* 7 U.S.C.

§ 2(a)(1)(A). Nothing in Section 27a or its legislative history purports to address the Part 190 Rules or otherwise restrict the CFTC from exercising regulatory authority over what plainly are *futures* transactions, notwithstanding that a letter of credit forms part of the consideration.

CONCLUSION

For the foregoing reasons, the CFTC supports the Trustee's motion for summary judgment.

Respectfully submitted,

COMMODITY FUTURES TRADING COMMISSION

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CERTIFICATE OF SERVICE

I hereby certify that on November 16, 2012, I caused the foregoing document to be served via the Court's CM/ECF system.

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