

**Response Deadline: January 9, 2012**  
**Reply Deadline : January 18, 2012**

HUGHES HUBBARD & REED LLP  
One Battery Park Plaza  
New York, New York 10004  
Telephone: (212) 837-6000  
Facsimile: (212) 422-4726

Attorneys for James W. Giddens,  
Trustee for the SIPA Liquidation of MF Global Inc.

**UNITED STATES BANKRUPTCY COURT  
SOUTHERN DISTRICT OF NEW YORK**

In re

MF GLOBAL INC.,

Debtor.

Case No. 11-2790 (MG) SIPA

**TRUSTEE'S MEMORANDUM REGARDING THE LEGAL  
PRINCIPLES AND FRAMEWORK FOR THE ALLOCATION AND  
DISTRIBUTION OF CUSTOMER PROPERTY**

## Table of Contents

	<u>Page</u>
PRELIMINARY STATEMENT .....	1
FACTUAL BACKGROUND.....	4
THE DETERMINATION AND ALLOCATION OF CUSTOMER PROPERTY FOR CLAIMS BY MFGI’S COMMODITY CUSTOMERS .....	5
I.    The Statutory And Regulatory Framework for Determining Claims and Allocating and Distributing Commodity Customer Property. ....	5
A.    The Applicable Statutes and Regulations. ....	6
B.    The Fund of Commodity Customer Property Will Be Distributed to MFGI’s Public Customers First. ....	8
C.    Segregated or “Readily Traceable” Customer Property Will Be Allocated and Distributed Pro Rata By Account Class. ....	10
II.   The Determination of Net Equity For Commodity Customers. ....	12
III.  The Rights of Commodity Customers Claiming Specifically Identifiable Property. ....	16
THE DETERMINATION AND ALLOCATION OF CUSTOMER PROPERTY FOR CLAIMS BY MFGI’S SECURITIES CUSTOMERS .....	19
I.    The SIPA Statutory Scheme .....	19
A.    Customers and “Customer Property.” .....	19
B.    The Determination of Net Equity for Securities Customers’ Claims.....	22
C.    SIPA Mandates the Use of “Any Other Assets” to Cover Deficits in the Reserve Account.....	22
II.   The Additional Rights Afforded Securities Customers to SIPA Coverage.....	23
GENERAL ESTATE PROPERTY.....	24
CONCLUSION.....	25

## Table of Authorities

	<u>Page</u>
<b>CASES</b>	
<u>In re Bernard L. Madoff Inv. Sec. LLC</u> , 654 F.3d 229 (2d Cir. 2011) .....	5
<u>CFTC v. Topworth Int’l Ltd.</u> , 205 F.3d 1107 (9th Cir. 1999) .....	14
<u>Ferris, Baker Watts, Inc. v. Stephenson (In re MJK Clearing)</u> , 286 B.R. 109 (Bankr. D. Minn. 2002).....	22
<u>In re Griffin Trading Co.</u> , 245 B.R. 291 (Bankr. N.D. Ill. 2000), <u>vacated</u> , 270 B.R. 882 (Bankr. N.D. Ill. 2001) .....	9, 24
<u>Horowitz v. Sheldon (In re Donald Sheldon &amp; Co.)</u> , 148 B.R. 385 (Bankr. S.D.N.Y. 1992) .....	22, 23
<u>In re Klein Maus &amp; Shire Inc.</u> , 301 B.R. 408 (Bankr. S.D.N.Y. 2003) .....	20
<u>Kusch v. Mishkin (In re Adler, Coleman Clearing Corp.)</u> , No. 95-08203, 1998 Bankr. LEXIS 1076 (Bankr. S.D.N.Y. Aug. 24, 1998), <u>aff’d</u> , 202 F.3d 202 (2d Cir. 2000) .....	5
<u>In re Lehman Brothers Inc.</u> , No. 08-01420 (JMP).....	23
<u>Mishkin v. Siclari (In re Adler Coleman Clearing Corp.)</u> , 277 B.R. 520 (Bankr. S.D.N.Y. 2002) .....	20
<u>The Oxford Organisation v. Peterson (In re Stotler and Co.)</u> , 144 B.R. 385 (N.D. Ill. 1992) .....	9
<u>SEC v. F.O. Baroff Co.</u> , 497 F.2d 280 (2d Cir. 1974) .....	20
<u>Securities Investor Protection Corp. v. MF Global Inc.</u> , Case No. 11-CIV-7750 (PAE).....	4
<b>STATUTES AND RULES</b>	
7 U.S.C. § 6d.....	6
7 U.S.C. § 24.....	6
11 U.S.C. § 726.....	24
11 U.S.C. § 761(9).....	6
11 U.S.C. § 761(10) .....	6
11 U.S.C. § 766(c) .....	18
11 U.S.C. § 766(d) .....	18

## Table of Authorities

	<u>Page</u>
11 U.S.C. § 766(h) .....	8, 12
11 U.S.C. § 766(j)(2) .....	14
15 U.S.C. § 78aaa <i>et seq.</i> .....	1
15 U.S.C. § 78eee(b)(3) .....	4
15 U.S.C. § 78eee(b)(4) .....	4
15 U.S.C. § 78fff-2(b).....	22
15 U.S.C. § 78fff-2(c)(1) .....	20
15 U.S.C. § 78fff-2(c)(2) .....	21
15 U.S.C. § 78fff-3(a).....	23
15 U.S.C. § 78fff(a) .....	19
15 U.S.C. § 78fff(a)(1).....	20
15 U.S.C. § 78fff(a)(1)(A) .....	21
15 U.S.C. § 78fff(e) .....	20
15 U.S.C. § 78lll(2).....	20
15 U.S.C. § 78lll(3).....	21
15 U.S.C. § 78lll(4).....	20, 21
15 U.S.C. § 78lll(4)(E).....	22, 23, 24
Commodity Exchange Act § 4d.....	<i>passim</i>
Securities Investor Protection Act of 1970 .....	1
 <b>REGULATIONS</b>	
17 C.F.R. § 1.3 .....	10
17 C.F.R. §1.20.....	6
17 C.F.R. §1.25 .....	6
17 C.F.R. § 30.7 .....	2, 6, 8, 10, 11
17 C.F.R. Pt. 190, App. B .....	15

## Table of Authorities

### Page

17 C.F.R. § 190.01 .....	<i>passim</i>
17 C.F.R. § 190.05 .....	11, 12
17 C.F.R. § 190.07 .....	12, 13, 14, 15, 16
17 C.F.R. § 190.08 .....	8, 9, 10, 11, 18, 24

### **LEGISLATIVE AND ADMINISTRATIVE MATERIALS**

46 Fed. Reg. 57535 (Nov. 24, 1981).....	7, 8, 11, 13, 16, 17
48 Fed. Reg. 8716 (Mar. 1, 1983).....	7, 8, 12, 15, 17, 24
67 Fed. Reg. 52641 (Aug. 13, 2002) .....	15
68 Fed. Reg. 5545 (Feb. 4, 2003) .....	16
CFTC Interpretive Letter No. 90-1 (Jan. 19, 1990) .....	17
H.R. Rep. No. 95-746 (1977) .....	20

### **OTHER AUTHORITIES**

1-6 Collier on Bankruptcy ¶¶ 12.03- 761.18 (16th ed. 2011).....	5, 6, 10, 13, 15, 21, 22, 24
---	------------------------------

James W. Giddens (the “Trustee”), as Trustee for the liquidation of MF Global Inc. (“MFGI”) under the Securities Investor Protection Act of 1970, as amended (“SIPA”), 15 U.S.C. § 78aaa *et seq.*, by and through his undersigned counsel, respectfully submits this memorandum, pursuant to the Court’s direction, to set forth the Trustee’s position regarding how he expects to allocate and distribute the property of the MFGI estate under the statutory and regulatory provisions applicable to this proceeding, including 15 U.S.C. 78fff to 78fff-4, sections 105(a), 764, and 766(c) of title 11 of the United States Code (the “Bankruptcy Code”), and 17 C.F.R. §§ 190.01 through 190.10 (the “Part 190 Regulations”). The Trustee respectfully states as follows:

### **PRELIMINARY STATEMENT**

1. Before MFGI was placed into liquidation, it was both a futures commission merchant (“FCM”) and a securities broker-dealer, and therefore subject to two separate regulatory regimes, which imposed different regulatory requirements on MFGI with respect to customer funds and property and which have different protections for MFGI customers in this liquidation proceeding. Under both liquidation regimes, customers are entitled to a pro rata share of the applicable pools of customer property. We outline below the legal framework within which the Trustee will exercise his broad discretion in determining how to apply the principles to the particular facts of MFGI’s liquidation.

2. As an FCM, MFGI was required by the Commodity Exchange Act (“CEA”) and Commodity Futures Trading Commission (“CFTC”) regulations to segregate or secure funds and property held for its commodity futures customers. The Part 190 Regulations refer to six potential types of commodity account classes. Two of the main classes of property are for: assets held for commodity customers trading on domestic exchanges—whose funds and property MFGI was required to segregate pursuant to Section 4d of the CEA; and assets

held for MFGI commodity customers trading on foreign futures exchanges—for whom MFGI was required to maintain secured accounts under Rule 30.7. In addition, the Part 190 Regulations provide for a “delivery account” class for narrowly defined subsets of specifically identifiable property, which may also be applicable to this liquidation. It is possible that further investigation or claims submitted will warrant additional pools. Based on the regulatory provisions, the claims received, and the books and records of MFGI, the Trustee will marshal separate pools of customer property for the account classes reflected for MFGI’s commodity customers.

3. To marshal separate pools of commodity customer property for each account class, the customer property so noted on MFGI’s books and records as being segregated for that pool of customer property class plus customer property “readily traceable” to that class will be allocated to the pool. Thereafter, from the claims submitted by FCM customers and MFGI’s records, the “net equity” (essentially the assets held less indebtedness or set offs) for each customer per class will be determined in the claims process. To the extent that a particular account class was treated together with another class, those classes may be merged and treated as one class. Each distinct class will have its own pool of assets to distribute and may suffer from its own shortfall (if any); the distributions to customers from each particular pool are expected to be made pro rata.

4. FCM customers for whom MFGI was holding specifically identifiable property (“SIP”) have an additional right under the Part 190 Regulations. These customers may instruct the Trustee to return or transfer their SIP, up to the amount of the funded portion of their net equity claim from their pro rata share of the applicable customer pool. As described in more detail below, to the extent the value of an FCM customer’s SIP which is not

margining an open contract exceeds the estimated funded portion of his net equity claim, the customer may obtain the property by providing cash for the unfunded portion. For SIP margining an open contract, the customer may obtain the property by paying the estate the full fair market value of the property. This right does not expand or change the principle that customers within the same customer account class or pool will receive equivalent pro rata shares of the estate, regardless of the form in which their customer property was being held.

5. For securities customers, the SEC's Customer Protection Rules required MFGI to maintain customer securities separately and to establish reserves for customer funds. Allowed customer claims will share pro rata in the pool of securities customer property. In addition, in the event and to the extent that this pool is insufficient to satisfy the allowed net equity for each securities customer claim, SIPC provides funding for up to \$500,000 per customer, of which up to \$250,000 may be for customer cash deposited for securities transactions. In the event that the allowed net equity claims of MFGI's securities customers are not satisfied from the pool of securities customer property and SIPC coverage, such customers will have additional rights to share in the other assets of the estate.

6. Claims by MFGI customers other than customer claims (such as tort or breach of contract claims, or claims for financial products other than those covered by SIPA and CEA) and claims by MFGI's unsecured creditors are relegated to the general estate, which is comprised essentially of other property of MFGI not required for or not subject to the customer protection provisions described above. Determinations of most general creditor claims will likely be deferred until the extent of customer claims have been preliminarily determined and it is determined whether there will be a meaningful estate after any reallocation



of assets to compensate for segregation or compliance failures affecting customer funds, as set forth below.

7. As part of the bulk transfer process, the Trustee has already returned to many customers substantial amounts of their Section 4d property, prior to any claims determinations. Ultimately, however, customers' claims will need to be resolved and finally "trued up" by review and determination of their allowed net equity, distribution of customer property on a pro rata basis from the appropriate pools, and marshaling additional assets deemed customer property, if any, for such claims.

### **FACTUAL BACKGROUND**

8. On October 31, 2011 (the "Filing Date"), the Honorable Paul A. Engelmayer, United States District Court for the Southern District of New York, entered an Order (the "MFGI Liquidation Order", ECF No. 1) commencing liquidation of MFGI pursuant to the provisions of SIPA in the case captioned Securities Investor Protection Corp. v. MF Global Inc., Case No. 11-CIV-7750 (PAE).

9. The MFGI Liquidation Order, inter alia: (i) appointed James W. Giddens as Trustee for the liquidation of the business of MFGI pursuant to 15 U.S.C. § 78eee(b)(3); (ii) appointed Hughes Hubbard & Reed LLP counsel to the Trustee pursuant to 15 U.S.C. § 78eee(b)(3); and (iii) removed the case to this Court as required for SIPA cases by 15 U.S.C. § 78eee(b)(4) (the "SIPA Proceeding"). (MFGI Liquidation Order ¶¶ II, IX.)

10. The Trustee has begun liquidating the business of MFGI, seeking to promptly satisfy in part customer claims by bulk transfers of commodity customers' accounts (all from MFGI's Section 4d accounts). Additional transfers for U.S. commodity futures accounts and customer securities accounts are in process. The Court also has authorized the Trustee's parallel claims processes for commodity futures customers and securities customers.

11. At a hearing on November 17, 2011, the Court requested that the Trustee, the CFTC, and SIPC submit their positions “on the rules that apply to distribution from whatever funds are available for distribution.” (Tr. at 24:19-20.)

**THE DETERMINATION AND ALLOCATION OF CUSTOMER PROPERTY FOR  
CLAIMS BY MFGI’S COMMODITY CUSTOMERS**

**I. The Statutory And Regulatory Framework for Determining Claims and Allocating and Distributing Commodity Customer Property.**

12. Determining the claims of and allocating customer property to MFGI’s commodity customers involve the interplay of the Bankruptcy Code, the CEA, and the Part 190 Regulations, within the context of a SIPA proceeding. Under SIPA, the Trustee is accorded considerable discretion in carrying out his responsibilities, to an even greater extent than a trustee in a bankruptcy liquidation. See 1 Collier on Bankruptcy ¶ 12.02 (16th ed. 2011). The Second Circuit has emphasized that courts should defer to a SIPA trustee’s reasonable discretionary determinations, including as to the methods for determining net equity and classifying property under his control. See In re Bernard L. Madoff Inv. Sec. LLC, 654 F.3d 229, 238 n.7 (2d Cir. 2011) (“a reviewing court could and should accord a degree of deference to such an exercise of discretion so long as the method chosen by the trustee [for determining net equity] . . . is not clearly inferior to other methods under consideration”); Kusch v. Mishkin (In re Adler, Coleman Clearing Corp.), No. 95-08203, 1998 Bankr. LEXIS 1076 at \*97 (Bankr. S.D.N.Y. Aug. 24, 1998) (application of SIPA is “committed to the broad discretion of a SIPA trustee in administering the estate of a failed broker-dealer”), aff’d, 208 F.3d 202 (2d Cir. 2000). We outline below the relevant regulatory provisions and policy considerations that the Trustee expects to apply in carrying out his statutory duties under SIPA.

A. The Applicable Statutes and Regulations.

13. The Bankruptcy Code describes a “customer” for purposes of a commodity broker liquidation proceeding as an entity that claims “a commodity contract made, received, acquired, or held by or through such futures commission merchant in the ordinary course of such futures commission merchant’s business” or cash, security or property deposited or paid for or to margin such commodity contracts. 11 U.S.C. § 761(9). The Bankruptcy Code also defines the broad categories of “customer property”. See 11 U.S.C. § 761(10).

14. In turn, as part of the CEA, Congress empowered the CFTC to provide, by rule or regulation, the boundaries of “customer property” and “specifically identifiable property” as well as how to determine the “net equity of a customer.” 7 U.S.C. § 24. The regulations were undertaken within the context of the CFTC’s regulation of commodity brokers’ handling of customer property.<sup>1</sup> Under Section 4d of the CEA, an FCM must maintain a “Customer Segregated Funds Account” to hold the assets of commodity or option customers being traded on “domestic” futures markets. CEA § 4d (codified at 7 U.S.C. § 6d); 17 C.F.R. § 1.20. For U.S. customers trading futures or options on futures on “foreign” commodity exchanges, a broker must maintain their assets in a separate “Customer Secured Amount Account.” 17 C.F.R. § 30.7. The investments that FCMs may make for these two types of regulatory accounts differ, as do the acceptable depositories and possible means of computing segregation or reserve requirements, with a broader scope permitted with respect to foreign futures secured accounts. See 6 Collier, supra, ¶ 760.07[1] (citing 17 C.F.R. § 30.7).

---

1. The regulations regarding investments have recently been amended to restrict FCM investments in sovereign debt. See 17 C.F.R. § 1.25(b)(4)(i)(D). The description in text is of the regulations in effect on the Filing Date.

These differences may in turn impact the extent of customer property in each category that is ultimately available for distribution.

15. Although there is very limited case law regarding FCM liquidation, the CFTC's detailed Part 190 Regulations provide the legal framework for the Trustee's allocation and distribution of MFGI's FCM customer property. As summarized by the CFTC when the regulations were proposed, the governing principles are to accord priority to customer claims and to provide pro rata distribution among customers:

The customer protections are essentially: (1) Priority over all claims except claims "attributable to the administration of customer property"; (2) across-the-board application of pro rata distribution even to specifically identifiable property; and (3) some customer control over the disposition of customer property, in particular the disposition of open commodity contracts.

46 Fed. Reg. 57535, 57535 (Nov. 24, 1981).

16. From the outset, the CFTC recognized and advised the industry that "the most difficult problems" in customer allocation and distribution would arise in circumstances such as appear here, where the broker did not comply with its segregation obligations, creating a shortfall in customer property, and there are both securities and commodity customers. See id. at 57553 ("The Commission expects that the most difficult problems in recovering funds which are not properly segregated for commodity customers will arise in joint commodity broker-securities dealer bankruptcies.").

17. The CFTC acknowledged that the estates of customer property should be administered separately. See 48 Fed. Reg. 8716, 8719 (Mar. 1, 1983) (CFTC describing that securities broker and commodity broker liquidation rules "are structured so that any customer property held by such a [joint broker] can be distributed as separate estates under the two

subchapters.”). To the extent competing claims arise between estates, the CFTC acknowledged the need to address them case-by-case in the specific context of a particular bankruptcy:

The Commission has determined that the problems of a joint commodity broker-security dealer bankruptcy may not lend themselves to any regulatory solution other than the establishment of a presumption which permits the following of diverted funds into the debtor’s general estate. It appears to the Commission that the problems presented by the bankruptcy of a joint commodity broker-security dealer are best handled on a case-by-case basis because of the difficulty of adequately anticipating the issues which will need to be addressed, the likelihood that each such bankruptcy will be unique, and the many different and competing interests involved.

Id. at 57553.

B. The Fund of Commodity Customer Property Will Be Distributed to MFGI’s Public Customers First.

18. “Public customers” of MFGI—essentially all customers with commodity accounts other than proprietary accounts of MFGI, MFGI affiliates, and insiders, see 17 C.F.R. § 190.01—have priority claims to customer property. See 11 U.S.C. § 766(h) (“[T]he trustee shall distribute customer property ratably to customers on the basis and to the extent of such customers’ allowed net equity claims, and in priority to all other claims” excepting certain administrative claims).

19. The substantial customer property pools that MFGI segregated or set aside as secured under CEA Section 4d and Rule 30.7 are the starting points for allocation. But customer property is not limited to property that was secured or segregated. Rather, the definition of customer property includes customer property that should have been segregated, as well as recoveries on behalf of customers’ accounts. E.g., 17 C.F.R. § 190.08(a)(1)(ii)(F) (customer property includes property which was “unlawfully converted but is a part of the debtor’s estate”). See also, 48 Fed. Reg. at 8717 (“The Commission believes that the Bankruptcy Act makes clear that the customer priority for commodity customers is to be

broader than a priority in the property actually segregated by the debtor in their behalf”). In addition, the CFTC regulations provide that where the customer property is “insufficient to satisfy in full all claims of public customers,” that debtor’s cash, securities or other property, such as “trading or operating accounts and commodities of the debtor held in inventory,” are to be included in the customer property pool. 17 C.F.R. § 190.08(a)(1)(ii)(J). The scope of the “other property” that may be allocated to commodity customers is not certain even when only an FCM liquidation is involved—indeed, one court has rejected this regulation as inconsistent on its face with the Bankruptcy Code provision that commodity customer shortfalls are general estate claims<sup>2</sup>—and the additional issues potentially arising in a joint FCM-securities broker liquidation will require additional attention once the scope of claims and of the respective customer estates are known.

20. Certain categories of claims are explicitly excluded from customer property, including damages claims, forward contracts, and other claims not based on property received, acquired or held by the debtor from or for the customer. 17 C.F.R. § 190.08(a)(2).

21. Claims of non-public customers are subordinated to the claims of public customers and constitute a separate class for purposes of calculating distribution amounts. Thus, no portion of the commodity customer property estate may be allocated to pay non-public customer claims until all public customer claims have been satisfied in full. 17 C.F.R. § 190.08(b). Proprietary accounts of MFGI’s affiliates, for example, would fall in this

---

2. In re Griffin Trading Co., 245 B.R. 291 (Bankr. N.D. Ill. 2000), vacated, 270 B.R. 882 (Bankr. N.D. Ill. 2001). Cf. The Oxford Organisation v. Peterson (In re Stotler and Co.), 144 B.R. 385, 388 (N.D. Ill. 1992) (noting that although a customer’s claim is limited to his net equity, the estate’s other funds are to be tapped “to satisfy in full all claims of public customers.”).

category and are excluded from public customer distributions. See 17 C.F.R § 190.01(bb); 17 C.F.R. § 1.3(y).

C. Segregated or “Readily Traceable” Customer Property Will Be Allocated and Distributed Pro Rata By Account Class.

22. CFTC regulations identify six potential account classes: Futures accounts; foreign futures accounts; leverage accounts; commodity option accounts; delivery accounts; and cleared OTC derivatives accounts. 17 C.F.R. § 190.01(a). Where accounts were treated as one by MFGI, the accounts may be treated as one account class. Id. See also 6 Collier, supra, ¶ 761.18[1] (“The number of separate estates for distribution purposes will depend, in part, on whether commodity options account and/or cleared OTC derivatives accounts have been commingled with futures account positions.”). The Trustee’s investigation is ongoing; but, based on preliminary information, MFGI did not maintain leverage accounts, and commingled domestic futures accounts with commodity option and other CEA Section 4d domestic accounts. Foreign futures accounts were held and reported separately. Cleared OTC derivatives cleared in the U.S. may have been included with Section 4d accounts, and whether foreign cleared derivatives were included with 30.7 funds is not yet certain. The Trustee anticipates that information provided by claimants in the claims process and in comparing claimants’ records to MFGI’s will enable these preliminary account class divisions to be determined.

23. Thus, “property held by or for the account of a customer, which is segregated on behalf of a specific account class, or readily traceable on the filing date to customers of such account class, must be allocated to the customer estate of the account class for which it is segregated or to which it is readily traceable.” 17 C.F.R. § 190.08(c)(1). As described by the CFTC when it first proposed the Part 190 Regulations, this separate account

class treatment was intended to track the different regulatory protections: “This approach is consistent with the fact that differing segregation requirements exist for different classes of accounts. Obviously, much of the benefit of segregation would be lost if property segregated on behalf of a particular account class could be allocated to pay the claims of customers of a different account class for which less stringent segregation provisions were in effect.” 46 Fed. Reg. at 57554. Accordingly, subject to additional information from customer claims and MFGI’s books and records, the Trustee anticipates that foreign futures will constitute one principal account class—corresponding with the MFGI foreign secured customer property pool under Rule 30.7 (potentially with foreign-cleared OTC derivative-related assets if they were not separately maintained). The other principal account class likely will be comprised of domestic futures accounts, commodity option accounts, and, potentially, cleared OTC derivatives accounts that cleared on domestic exchanges, and will share in the MFGI Section 4d segregated customer property pool.<sup>3</sup>

24. The Part 190 Regulations also provide for a separate account class of “delivery accounts,” which encompasses only the “accounts prominently designated as such in the records of the debtor which contains only the specifically identifiable property associated with delivery set forth in §190.01(kk)(3), (4) and (5) . . .” 17 C.F.R. § 190.05(a)(2). Section

---

3. Customer property which is not segregated on behalf of a specific account class and is not “readily traceable on the filing date” to customers of such account class will be allocated pursuant to the regulations. 17 C.F.R. § 190.08(c)(2). The allocation procedure provides that the customer property pool for the account class with the lowest percentage funding for public customers will be augmented from non-segregated, non-traceable customer property. If the funded percentage of that account class reaches the level of the next lowest funded account class, the remaining non-segregated, non-traceable customer property would then be allocated to both of the lowest funded account classes. Based on the regulatory shortfalls identified to date, the Trustee anticipates that segregated and readily traceable customer property may be insufficient to satisfy customer claims, and that the customer property funds will need to be augmented from any non-specific customer property.



190.01(kk)(3) provides that “warehouse receipts, bills of lading or other documents of title, or physical commodities” which as of the Filing Date “can be identified on the books and records of the debtor as received from or for the account of a particular customer as held specifically for the purpose of delivery or exercise.” Sections 190.01 (kk)(4) and (5) relate to cash deposited prior to the Filing Date for physical delivery of physical commodities, which is identified on the books and records of the debtor for the account of a particular customer. (If not specifically identifiable, the price or proceeds are subject to the general pro rata distribution. See 17 C.F.R. § 190.05(a)(3).) Property of the delivery account class is still subject to pro rata distribution but only within the class, to prevent the dilution of segregated property in this category by shortfall among other types of customers. See 48 Fed. Reg. at 8731 (“[A]lthough this property will not be distributed to the extent its value exceeds a claimant’s net equity claims and will be distributed pro rata among claimants which are of the same class, it will not be diluted by other types of customers claims.”). Whether a claimant’s property potentially falling within the “delivery account” class was so identified in MFGI’s books and records and meets the other criteria in the regulations will be determined in the claims process.

## **II. The Determination of Net Equity For Commodity Customers.**

25. The Trustee is required to distribute MFGI’s customer property to commodity customers to the extent of their allowed net equity. 11 U.S.C. § 766(h). Net equity is the customer’s total customer claim less indebtedness of the customer to the debtor. Net equity does not, however, include claims a person may have against the debtor for matters other than transactions in commodities. 17 C.F.R. § 190.07(b). Net equity is determined separately for each customer for each account class held by that customer. 17 C.F.R. § 190.07(a). The allowed net equity claim of a customer is “equal to the aggregate of the

funded balances of such customer's net equity claim for each account class plus or minus" adjustments for operations subsequent to the primary liquidation date. Id.

26. The six-step process for calculating net equity is described in 17 C.F.R. § 190.07(b), which is intended "to forestall inappropriate setoffs and valuation disputes, and to equalize the percentage of bankruptcy loss borne by public customers." 6 Collier, supra, ¶ 761.18. First, the equity balance of each customer account is determined by adding the (i) ledger balance,<sup>4</sup> (ii) open trade balance, and (iii) current realizable market value.<sup>5</sup> 17 C.F.R. § 190.07(b)(1). Next, the credit and debit equity balances of all accounts of the same class held by the customer in the same capacity are aggregated. 17 C.F.R. § 190.07(b)(2). Accounts maintained in a separate capacity—such as for the benefit of a minor or in the name of an executor—are deemed to be held in a separate capacity from accounts held by such guardian or executor's individual capacity. 17 C.F.R. §§ 190.07(b)(2)(ii)-(iii). The third step in calculating a customer's net equity is to determine any setoffs. 17 C.F.R. § 190.07(b)(3). This step deducts "from a customer's net equity claim any obligation the customer may owe the debtor which has not already been deducted in the computation of his account equity." 46 Fed. Reg. at 57549.<sup>6</sup> Net equity of one customer may not be offset against the net equity of another

- 
4. The ledger balance is determined by adding (i) cash deposited to purchase, margin, guarantee, secure, or settle a commodity contract; (ii) the cash proceeds of such cash, or of securities or other property; (iii) gains realized on trades and then subtracting (i) losses realized on trades, disbursements to or on behalf of the customer; and (ii) the normal costs (such as payment of commissions, interest, taxes, transaction fees) attributed in connection with the purchase, sale, exercise or liquidation of any commodity contract in the account. 17 C.F.R. §§ 190.07(b)(1)(A)(1)-(3).
  5. The current realizable market value is determined as of the close of the market on the last preceding market day. 17 C.F.R. § 190.07(b)(1)(iii).
  6. Thus, "if the customer owes the debtor \$5,000 on an outstanding loan which is due and payable upon demand, that \$5,000 would be subtracted from such customer's account equity to determine his net equity claims." Id.

customer. 17 C.F.R. § 190.07(b)(3)(i). However, a customer's negative equity balance in one account class must be set off against a positive equity balance in any other account class of such customer held in the same capacity. 17 C.F.R. § 190.07(b)(3)(iii).

27. Next, corrections for distributions made prior to liquidation must be determined. The value on the date of transfer or distribution of any property transferred or distributed subsequent to the filing date and prior to the primary liquidation date with respect to each class of account held by a customer must be added to the equity obtained for that customer for accounts of that class. 17 C.F.R. § 190.07(b)(4). Step five entails correcting the net equity calculated for misestimates or errors including corrections for subsequent events such as the liquidation of unliquidated claims at a value different from the estimated value previously used in computing net equity. 17 C.F.R. § 190.07(b)(5). Finally, if the accounts of a customer contain commodity contracts which remain open subsequent to the primary liquidation date, the Trustee must adjust the net equity obtained for that customer. 17 C.F.R. § 190.07(b)(6).<sup>7</sup>

28. In determining net equity, customer property must be valued as of the date of its return or transfer. 17 C.F.R. § 190.07(e).<sup>8</sup> Thus, net equity fluctuates during the period that the debtor's estate contains open commodity contracts, with the customer bearing the risks of the fluctuations between the filing date and the liquidation date. As the CFTC noted,

- 
7. If the pro rata share of customer property is insufficient to pay the full amount of customer's allowed net equity claim, the unpaid portion is entitled to general creditor status. See 11 U.S.C. § 766(j)(2).
  8. The method for valuation of various contracts and property is set forth in 17 C.F.R. §§ 190.07(e)(1)-(5). E.g., CFTC v. Topworth Int'l Ltd., 205 F.3d 1107, 1116 (9th Cir. 1999) (noting that with respect to "bucketed contracts," pursuant to § 190.07(e)(3), "[t]he value of a commodity contract which has not been established in fact shall be deemed to be equal to the value of the total deposit made by a customer in respect to such contract.").

“regardless of what valuation date is chosen, there will be ‘winners and losers,’ *i.e.*, those persons which would have profited more or less if a different valuation date had been chosen.” 48 Fed. Reg. at 8735.<sup>9</sup>

29. Funded balance is defined as “a customer’s pro rata share of the customer estate with respect to each account class available as of the primary liquidation date for distributions to customers of the same class.” 17 C.F.R. § 190.07(c). A customer’s funded balance is “equal to the sum of (a) the ratio of such net equity claim (less margin payments made by the customer during the bankruptcy case but prior to the primary liquidation date) to the sum of all net equity claims in such class (less the sum of all such margin payments) *times* the value of all property segregated on behalf of all accounts of such class or allocated to such class (including the value of any accounts or property distributed prior to the primary liquidation date), *plus* (b) the amount of margin payments made by the customer prior to the primary liquidation date.” 6 Collier, *supra*, ¶ 761.18 (citing 17 C.F.R. §§ 190.07(c), (e)). The funded balance is then adjusted to take into account operations subsequent to the primary liquidation date.<sup>10</sup>

- 
9. If identical commodity contracts, securities or other property are liquidated on the same date, but cannot be liquidated at the same price, the Trustee may use the weighted average of the liquidation prices in computing the net equity of each customer holding such contracts. 17 C.F.R. § 190.07(e).
  10. The Part 190 Regulations include additional provisions for customer funds held by an FCM in a depository outside of the U.S. or in a foreign currency, which specifies additional allocation rules in the event of shortfalls in such customer funds. See 17 C.F.R. Pt. 190, App. B, Framework 2 (Special Allocation of Shortfall to Customer Claims When Customer Funds are Held in a Depository Outside of the United States or in a Foreign Currency). These provisions deal with losses arising when customers authorize customer funds to be so held but a “sovereign action” causes a further shortfall; the portion of the shortfall arising from the sovereign action is allocated only to those customers which undertook such risks, and does not dilute recoveries by other customers in the same account class that did not subject themselves to the risks of foreign held or foreign denominated currency. See CFTC, Denomination of Customer Funds and Location of Depositories, 67 Fed. Reg. 52641, 52642 (Aug. 13, 2002). It is not yet known whether this provision will apply to MFGI customers or whether

(Footnote continued on next page)

30. As the CFTC has explained, the changing valuation of customer net equity complicates the distribution process:

The fact that net equity is a changing value would not create any problems of computation if it could be assumed that, in every commodity broker bankruptcy, there would be sufficient property in segregation for all customers to be paid their equity balances in full. The proposed calculation of net equity is complex because it assumes that in such cases complete segregation is likely to be the exception rather than the rule. In the event of undersegregation, it is this fluctuating concept of “net equity” which increases the difficulty of insuring a pro rata distribution of customer property.

46 Fed. Reg. at 5746-47.

### **III. The Rights of Commodity Customers Claiming Specifically Identifiable Property.**

31. Commodity customers with claims for “specifically identifiable property” (“SIP”) have additional rights under the Part 190 Regulations. SIP includes, among other things, (i) securities or warehouse receipts (and other documents of title) which margin, guarantee or secure an open commodity contract and which are held for the account of a customer, registered in a customer’s name, not transferable by delivery, and not a short-term obligation and, (ii) with respect to open commodity contracts, hedge positions held for the account of a customer in a designated hedge account. 17 C.F.R. §§ 190.01 (kk)(1)-(7).

---

(Footnote continued from previous page)

there will be account classes in which sovereign actions will affect some customer funds and not others. The Trustee will be in a better position to determine how best to exercise his discretion to apply this provision after review of the claims in this category, analysis of MFGI books and records regarding such claims, and the specifics regarding such shortfalls, if any, including discussions and negotiations with foreign administrators operating under foreign insolvency regimes. See 68 Fed. Reg. 5545, 5549 (Feb. 4, 2003) (“The Commission has purposely defined sovereign risk broadly so as to afford the bankruptcy trustee the ability to exercise its discretion and judgment to fully effectuate the purpose of this bankruptcy convention.”).

32. In consultation with the CFTC, the Trustee notified MFGI customers of their right to instruct the Trustee to return or transfer any SIP.<sup>11</sup> In addition, the Trustee has included Physical Customer Property in this category as part of the Third Bulk Transfer.<sup>12</sup>

33. This right to seek return of SIP does not change or expand claimants' rights to share pro rata in the relevant fund of customer property. Indeed,

[o]ne of the principal purposes of the Bankruptcy Reform Act of 1978 (11 U.S.C. § 101 *et seq.* (1982)) with respect to the bankruptcy of a FCM was to promote equitable treatment of customers and to provide equitable treatment of customers and to provide for an across-the-board application of pro rata distribution to all customer commodity accounts *whether or not the funds related to such accounts were maintained with separate depositories or were otherwise specifically identifiable.*

CFTC Interpretive Letter No. 90-1 (Jan. 19, 1990) (emphasis in original). See also 46 Fed. Reg. at 57538 (CFTC explaining rationale for narrow definition of SIP and why most SIP is subject to pro rata distribution, rather than reclamation).

34. To the extent a SIP claimant falls within the separate delivery account class described above, the expectation is that their pro rata share will be close to the value of SIP. See 48 Fed. Reg. at 8731. Whether some or all SIP claimants in the MFGI estate are within a separate account class for delivery accounts will be determined as part of the claims process.

---

11. Customers were originally directed to provide instructions by November 15, 2011. At the request of the Court, the deadline was subsequently extended and a new deadline of 5:00 p.m. on December 12, 2011 was established. To date, the Trustee has neither returned nor liquidated any specifically identifiable property.

12. For purposes of expediting the transfers, the Trustee, in consultation with the CFTC, sought and obtained approval to treat the Physical Customer Property as within the 4d Segregated Commodity Customer Property class, without prejudice to claimants' rights to establish that they should be treated as a separate class (presumably under the delivery account criteria described above.) CME Group included this interim distribution within the scope of its \$550 million guarantee, to enable prompt transfers to MFGI customers. See ECF No. 670.

35. As no customer may obtain more than his or her proportionate share of the property available to satisfy customer claims, a customer who instructs the Trustee to return or transfer SIP will be required to pay the estate, as a condition to the return, an amount determined by the Trustee. 11 U.S.C. § 766(c); 17 C.F.R. § 190.08(d).

36. With respect to property that is margining an open commodity contract, the customer may deposit cash with the Trustee in the amount equal to the full fair market value of such property on the return date (or the balance due on the return date on any loan by the debtor to the customer for which such property constitutes security, whichever is greater), and the Trustee shall return or transfer the property to a solvent broker. 11 U.S.C. § 766(d); 17 C.F.R. § 190.08(d)(1)(i).

37. If the property is not margining an open contract, the customer may proceed as described above. If the value of the customer's SIP exceeds the customer's pro rata share of the relevant estate (as estimated by the Trustee), the customer may obtain return of the SIP by depositing cash equal to the difference, "plus a reasonable reserve in the trustee's sole discretion." 17 C.F.R. § 190.08(d)(1)(ii). The Trustee also may require adequate security for any potential for overpayments. Id.

38. In conformance with the Court's December 9, 2011 Order regarding the Third Bulk Transfer, physical property is being transferred in bulk as if it were in the 4d asset class, without prejudice to the ultimate determination about the treatment of any such physical property, including whether any such physical property should be considered in a different class. It is possible that the Trustee could subsequently determine that any such property belongs, in fact, in a disparate class and that the relevant funds of customer property are more or less than the original estimate of each customer's pro rata share of the relevant pool, whether

the 4d Segregated Customer Property account class or as a separate class (such as any possible delivery account class).<sup>13</sup> A customer in that instance who has received SIP may receive a subsequent cash distribution, to equalize the pro rata shares with other customers in the same account class.

## **THE DETERMINATION AND ALLOCATION OF CUSTOMER PROPERTY FOR CLAIMS BY MFGP'S SECURITIES CUSTOMERS**

### **I. The SIPA Statutory Scheme.**

39. Congress enacted SIPA in 1970 to protect customers who have entrusted a securities broker-dealer with cash or securities in the ordinary course of its business. The declared purpose of a SIPA liquidation proceeding is “to deliver customer name securities to or on behalf of customers . . . and to distribute customer property and . . . satisfy net equity claims of customers . . . .” 15 U.S.C. § 78fff(a).

#### **A. Customers and “Customer Property.”**

40. SIPA affords special protections to “customers,” a class that includes:

any person . . . who has a claim on account of securities received, acquired, or held by the debtor in the ordinary course of its business as a broker or dealer from or for the securities accounts of such person for safekeeping, with a view to sale, to cover consummated sales, pursuant to purchases, as collateral security, or for purposes of effecting transfer.... The term “customer” includes -- (i) any person who has deposited cash with the debtor for the purposes of purchasing securities.... and (iii) any person who has a claim against the debtor arising out of sales or conversions of such securities.

---

13. To the extent such reclassification of accounts establishes an overpayment to an account class, the CME guarantee would apply.



15 U.S.C. § 7811(2).<sup>14</sup>

41. SIPA also contemplates two separate categories of estate property: customer property and the debtor's general estate. 15 U.S.C. § 7811(4). Customer property is accounted for and distributed to customers in a manner that is separate and distinct from the debtor's general estate. Id. The Trustee must allocate the property in his control between customer property and the general estate of the debtor. See 15 U.S.C. § 78fff-2(c)(1); 15 U.S.C. § 78fff(e). This structure is designed to meet the regulatory requirement that customer property will be held in a secure fashion and for prompt return in the event of liquidation, and also facilitates the expeditious return of customer property by allowing the Trustee to satisfy customer claims before completing a potentially lengthy or contentious general estate claims process. See 15 U.S.C. § 78fff(a)(1); H.R. Rep. No. 95-746, at 9-10 (1977).

42. The definition of customer property enacted as part of the 1978 amendments is broad and inclusive and reads as follows:

“[C]ustomer property” means cash and securities (except customer name securities delivered to the customer) at any time received, acquired, or held by or for the account of a debtor from or for the securities accounts of a customer, and the proceeds of any such property transferred by the debtor, including property unlawfully converted.

15 U.S.C. § 7811(4).

---

14. Claimants bear the burden of proving customer status. See Mishkin v. Siclari (In re Adler Coleman Clearing Corp.), 277 B.R. 520, 557 (Bankr. S.D.N.Y. 2002) (“well-established in the Second Circuit that a claimant bears the burden of proving that he or she is a ‘customer’ under SIPA”). The customer definition is narrowly construed in light of the statutory purpose, see In re Klein Maus & Shire Inc. 301 B.R. 408, 418 (Bankr. S.D.N.Y. 2003)(collecting cases), and must be established for particular transactions or accounts. See SEC v. F.O. Baroff Co., 497 F.2d 280, 282 n. 2 (2d Cir. 1974)(SIPA “contemplates that a person may be a ‘customer’ with respect to some of his claims for cash or shares, but not with respect to others.”).

43. Without limiting the definition of what may be considered customer property, SIPA then provides guidelines for allocation of assets to the customer property fund as follows:

The term “customer property” includes --

(A) securities held as property of the debtor to the extent that the inability of the debtor to meet its obligations to customers for their net equity claims based on securities of the same class and series of an issuer is attributable to the debtor’s noncompliance with the requirements of section 78o(c)(3) of this title and the rules prescribed under such section;

(B) resources provided through the use or realization of customers’ debit cash balances and other customer-related debit items as defined by the Commission by rule;

(C) any cash or securities apportioned to customer property pursuant to section 78fff(d) of this title;...

(E) any other property of the debtor which, upon compliance with applicable laws, rules and regulations, would have been set aside or held for the benefit of customers, unless the trustee determines that including such property within the meaning of such term would not significantly increase customer property.

Id.

44. Under SIPA, the Trustee is instructed to deliver “customer name securities” to or on behalf of customers, 15 U.S.C. § 78fff(a)(1)(A), subject to their first paying any indebtedness to the debtor. 15 U.S.C. § 78fff-2(c)(2). Prior to the 1978 amendments customer name securities were known as “specifically identifiable property,” which was a much broader concept covering a wider range of assets. See 6 Collier, supra, ¶ 740.01.

45. Customer name securities are limited to non-negotiable securities held by the debtor and registered in the name of the customer or in the process of being registered on the filing date. See 15 U.S.C. § 78lll(3); 1 Collier, supra ¶ 12.03[3]. Whether a security falls into this narrow category depends on whether it is negotiable, not whether it is identifiable. 1

Collier, supra, ¶ 12.13[2]. It is expected that the bulk of the MFGI securities will be handled in the claims process (or by transfers, where feasible), rather than returned as customer name securities.

B. The Determination of Net Equity for Securities Customers' Claims.

46. The SIPA claims process provisions direct that customers' net equity claims shall be determined to the extent "ascertainable from the books and records of the debtor" or as otherwise "established to the satisfaction of the trustee." 15 U.S.C. § 78fff-2(b). Securities are to be valued as of the Filing Date. Id.

47. Accordingly, determining the universe of securities customer claims to be allocated and the amounts of net equity will require claim by claim review and confirmation from MFGI's records of those claims not satisfied in full though the account transfer approved by the Court.

C. SIPA Mandates the Use of "Any Other Assets" to Cover Deficits in the Reserve Account.

48. Under SIPA § 78lll(4)(E), where property "would have been set aside or held for the benefit of customers" in compliance with applicable law but was not, "any other property of the debtor" may be devoted to filling the gap. Thus, "if the debtor miscalculated the funds to be set aside . . . or otherwise under funded such account, the trustee can recoup any deficiency from 'firm' property." Horowitz v. Sheldon (In re Donald Sheldon & Co.), 148 B.R. 385, 390 (Bankr. S.D.N.Y. 1992). This is because, in compliance with applicable laws, rules, and regulations, such assets should "have been set aside or held for the benefit of customers." Id.; accord Ferris, Baker Watts, Inc. v. Stephenson (In re MJK Clearing), 286 B.R. 109, 132 (Bankr. D. Minn. 2002) (finding debtor's other, non-15c3-3 accounts can be used to remedy the shortfall in the customer Reserve Account).

49. Thus, once the Trustee determines that there is a shortfall in assets because the debtor failed to maintain possession or control of customers' fully paid and excess-margin securities, or failed to maintain sufficient reserves in the Reserve Account, 15 U.S.C. § 78III(4)(E) would permit the Trustee to look to the debtor's other property, to replace the missing securities, with cash if necessary, and to rectify any deficiency in the Reserve Account, as if the debtor had complied with the appropriate regulations. See id. at 130-32 ("SIPA requires the trustee to correct the debtor's failure to comply, and apportion that cash to 'customer property' as if the debtor had complied with the appropriate regulations." (citation omitted) (emphasis added). Accord, In re Donald Sheldon, 148 B.R. at 390; Order Approving Trustee's Motion for Allocation of Property of the Estate, at 2, In re Lehman Brothers Inc., No. 08-01420 (JMP) (Bankr. S.D.N.Y. Mar. 2, 2010), ECF No. 2743. Pursuant to SIPA, the Trustee is thus authorized and required to remedy reserve shortfalls for MFGI's securities customers by allocating assets as necessary to customer property.

## **II. The Additional Rights Afforded Securities Customers to SIPA Coverage.**

50. Backstopping the fund of customer property for securities customers, SIPA provides that when the net equity of customers exceeds the pro rata share of customer property, SIPC will advance up to \$500,000 for securities claims of which up to \$250,000 may be for cash on deposit for securities transactions. 15 U.S.C. § 78fff-3(a). SIPC is subrogated to customer rights with respect to its advances under these provisions. Id.

51. Advances are not available to affiliates, insiders, brokers with proprietary accounts, and certain other claimants. Id. In this liquidation, most customers who might be eligible for SIPC cash advances will already have received these amounts through the securities account transfer approved by the Court.

## GENERAL ESTATE PROPERTY

52. The claims and distribution process for the general estate is governed by the general Bankruptcy Code provisions, see 11 U.S.C. § 726, and requires little elaboration.

53. As described above, SIPA provides for the allocation of non-customer property to satisfy demonstrated shortfalls in regulatory compliance to the extent necessary to satisfy customer claims. See supra ¶¶ 48-49. See also 1 Collier, supra ¶ 12.15[1] (“[T]he requirement in [15 U.S.C. § 78lll(4)(E)] that ‘any other property of the debtor’ be used to fill gaps caused by debtor noncompliance with [applicable laws, rules and regulations] has been held, in some circumstances, to extend to any firm property that would have been available to achieve compliance prior to the commencement of the liquidation. This firm property becomes part of the fund of customer property to the extent necessary to correct a deficit therein.”).

54. The CFTC Regulations adopt a similar regime, though it has been less frequently applied and the general estate property to which it may apply remains uncertain. See, e.g., 17 C.F.R. § 190.08(a)(1)(ii)(F) (customer property includes property which was “unlawfully converted but is a part of the debtor’s estate”); 17 C.F.R. § 190.08(a)(1)(ii)(J) (setting forth CFTC position that if customer property is “insufficient to satisfy in full all claims of public customers,” the debtor’s cash, securities or other property, such as trading or operating accounts and commodities, may included in the customer property pool)<sup>15</sup>; 48 Fed. Reg. at 8717 (“The Commission believes that the Bankruptcy Act makes clear that the

---

15. As noted above, one court held this provision exceeded CFTC’s authority on the grounds that it conflicts with the Bankruptcy Code provision, 11 U.S.C. § 766(J)(2), that commodity customers would have general creditor claims to the extent the pro rata distribution of customer property did not fully satisfy their net equity claims. In re Griffin Trading Co., 245 B.R. 291 (Bankr. N.D. Ill. 2000), vacated, 270 B.R. 883 (Bankr. N.D. Ill. 2001).

customer priority for commodity customers is to be broader than a priority in the property actually segregated by the debtor in their behalf.”).

55. General creditor claim forms have been sent to general creditors identifiable from the books and records of MFGI and the claims process has been widely publicized. It is not anticipated that most general creditor claims will be addressed until the extent of claims against the general estate, and assets potentially available to it after any required allocations, has become clearer.

### **CONCLUSION**

The Trustee respectfully submits that the foregoing constitutes the appropriate framework for allocating MFGI's estate and satisfying the claims against it.

Dated: New York, New York  
December 12, 2011

HUGHES HUBBARD & REED LLP

By: /s/ James B. Kobak, Jr.  
James B. Kobak, Jr.  
Christopher K. Kiplok  
Robert B. Funkhouser  
Christine M. Fitzgerald  
Josiah S. Trager  
Meaghan C. Gragg  
One Battery Park Plaza  
New York, New York 10004  
Telephone: (212) 837-6000  
Facsimile: (212) 422-4726  
Email: [kobak@hugheshubbard.com](mailto:kobak@hugheshubbard.com)

Attorneys for James W. Giddens, Trustee for  
the SIPA Liquidation of MF Global Inc.