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Ask the Professor: How Will The Seventh Circuit Rule In Sentinel II?

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fault, the CCP calculates the termination amount on its side of the market. Given the back-to-back relationship Client has with Clearing Member, economically speaking it takes the opposite side of the trade to the CCP. This means that the amount due to/payable by the Client will have been calculated on the other side of the market, even where Clearing Member is the defaulting party. The Client always pays the spread on close-out.

A word on collateral

Collateral arrangements are addressed only in broad-brush terms in the Addendum, and this is an area on which all parties will wish to focus. Under the standard terms, if the documentary framework to which the Addendum is attached is an ISDA Master Agreement, any existing collateral terms will be disapplied and a basic clearing-compatible CSA (with terms pre-completed by ISDA to correspond with the Addendum, a version of which is being released) will be deemed to apply.

Parties will wish to consider whether these terms reflect their best negotiated position, and—at a minimum—whether they reflect the practicalities of their collateral arrangements. As a consequence of the above, it should be noted that the Addendum default terms mean that any collateral transferred will constitute a title transfer financial collateral arrangement—and there is a provision extending this effect to collateral arrangements under non-ISDA documents which would otherwise not be captured by the deemed CSA described above.

CCP product offerings will also affect the collateral arrangements between Clients, Clearing Members and CCPs, and the documentary and practical arrangements surrounding those products will need to be considered alongside the Addendum collateral provisions.

Collectively, the above demonstrates the need for market participants to review and negotiate the Addendum with care. This is a complex and time-consuming process, and the volume of trading arrangements which need to be migrated to the cleared environment before the mandatory clearing deadline comes into effect under EMIR in 2014 means that the Addendum has not been published a moment too soon.

Ask The Professor: How Will The Seventh Circuit Rule in Sentinel II

BY RONALD H. FILLER

On January 4, 2013, Judge James Zagel ruled that $14,479,000 that had been distributed to the Customer Segregated Account of FCM in August 2007, must be returned back to the bankrupt estate of Sentinel. In August 2007, pursuant to a Court Order, funds had been distributed out of the bankrupt estate of Sentinel directly into Customer Segregated Accounts of several Futures Commission Merchants ("FCMs"), including the afore-mentioned Customer Segregated Account of FC Stone, the Defendant in this case. None of the funds were distributed directly to these FCMs.

Sentinel was an unusual FCM in that it did not engage in futures trading activities on behalf of its customers. Sentinel was registered as a Futures Commission Merchant ("FCM") solely to receive customer assets held by other FCMs. Sentinel, in essence, primarily provided an asset management investment service for two primary groups, namely (1) other FCMs which invested futures customer assets that they held in their respective Customer Segregated Accounts into the Sentinel Customer Segregated Account which, in turn, invested such assets as permitted by Commodity Futures Trading Commission ("CFTC") Rule 1.25 (hereinafter referred to as the "SEG 1 Pool"), and (2) other private investors, including hedge funds and even non-customer assets of FCMs (hereinafter referred to as the "SEG 3 Pool"). Accordingly, Sentinel was also registered as an investment adviser under the Investment Advisers Act of 1940.

The following activities took place during the period of August 13-21, 2007:
1. Around August 13, 2007, Sentinel sent letters to its customers stating that it had halted redemptions.

2. Nevertheless, Sentinel did start to distribute certain assets to its FCM customers who invested in the SEG 1 Pool.


4. On August 16, 2007, Sentinel started to sell a large amount of its portfolio to Citadel Trading ("Citadel"). These sales were eventually permitted by the U.S. Bankruptcy Court.13

5. On August 20, 2007, Sentinel filed an emergency order with the U.S. Bankruptcy Court for the Northern District of Illinois, seeking an order approving the distribution of the proceeds of the securities sold to Citadel.14 This Order was supported and approved by both the CFTC and the National Futures Association ("NFA").

6. On August 21, 2007, approximately $297 million of the assets managed by Sentinel were distributed directly into the Customer Segregated Account of the 14 FCMs that had invested their futures customer assets into the SEG 1 Pool. Of this amount, approximately $14,479,000 was distributed directly into the Customer Segregated Account of FCStone. Only a small amount was distributed to customers who had invested their assets in the SEG 3 Pool.

7. During the period of August 15-21, 2007, the amount distributed to the FCM Customer Segregated Accounts that had invested in the SEG 1 Pool represented approximately 32% of the total of the assets under management by Sentinel. If the distributions made to the FCM customer segregated accounts had been made on a pro rata basis, then applying this 32% test, FCStone would only have received $6,977,653 (versus the larger amount that was transferred into its Customer Segregate Account as noted above).15

Frederick J. Grede was appointed as the Liquidation Trustee of the Sentinel estate on December 17, 2007, some four months after the proceeds of the Citadel sale were distributed to the Customer Segregated Accounts of the various FCMs that invested their customer assets in the SEG 1 Pool.16 In September 2008, Mr. Grede brought this action to claw back the assets that were distributed to the SEG 1 Pool in August 2007 under the theory that the assets belonged pro rata to both the SEG 1 Pool and the SEG 3 Pool.17

Judge Zagel agreed with the Trustee and held, in essence, as follows:

1. The custody rule adopted by the Securities and Exchange Commission ("SEC") pursuant to the IAA, namely SEC Rule 206(4)-2, created a statutory trust protection as robust as those set forth under the Commodity Exchange Act ("CEA") and applicable CFTC regulations. Therefore, the SEG 3 Pool customers have an equally forceful claim to trust protection as the SEG 1 Pool customers.

2. FCStone, as the Defendant, is subject to common law tracing requirements due to the co-equal claims of the competing trust claimants.

3. The assets distributed to the Customer Segregated Accounts of the various FCMs back in August 2007 are property of the Sentinel bankrupt estate and were not "customer property" as defined by the CEA and applicable CFTC regulations.

4. The distribution made back in August 2007 to the FCStone's Customer Segregated Accounts was not authorized under the Bankruptcy Code or by the Bankruptcy Court.

This paper will discuss each of these legal conclusions and analyze the economic impact of the Sentinel decision on the U.S. futures markets. It will also examine the various briefs filed before the Seventh Circuit in this case and will thus attempt to determine how the Seventh Circuit might rule on the case on appeal.
THE FUTURES MARKETS IN GENERAL

The U.S. futures markets play an important economic role by permitting commercial end users to hedge their inventory, production and consumption activities through standardized futures contracts that consist of a variety of financial, agricultural, energy and other monetary end products. Historically, these future contracts dealt primarily with traditional agricultural products, such as corn, wheat and soybeans, but, today, financial futures involving interest rates, stock indices and currency futures comprise more than 80% of the daily volumes. A large asset manager can now easily hedge its investment market risks through a variety of financial products, including the S&P 500 Stock Index futures contract. If you’re not a hedger, then you are deemed to be a speculator.

Futures customers must open their futures account with a Futures Commission Merchant (“FCM”). Unlike bank accounts that are protected by FDIC insurance and stock accounts that are protected by SIPC insurance (both insurance plans paid by the U.S. government), futures customer accounts receive no such insurance protection. Therefore, Congress in 1936 adopted Section 4d(a) of the CEA to protect futures customers from any fraudulent or improper use of their assets by FCMs. The CFTC, the federal regulatory agency which has exclusive jurisdiction over the U.S. futures markets and FCMs, has issued various regulations that have provided further customer protections. In fact, until just recently with the failures of MF Global and Peregrine Financial Group, no FCM bankruptcy has resulted in any major shortfall to a Customer Segregated Account of an FCM. Thus, the CEA for over 75 years and applicable CFTC regulations provided important customer protections to futures customers. The Sentinel II case could result in even a greater loss of customer confidence in the U.S. futures markets, just as the recent MF Global and Peregrine FCM bankruptcies have, if the 7th Circuit affirms Judge Zagel’s decision.

The IAA, enacted in 1940 following the Great Depression, does not have any such customer asset protection provisions as the CEA. Section 206(4) of the IAA merely gives the SEC the right to adopt anti-fraud regulations to apply to investment advisers. In 1962, the SEC adopted SEC Rule 206(4)-2, which requires investment advisers to hold customer assets with a bank, a broker-dealer or an FCM. The IA Custody Rule, as it is commonly called, does not require many of the regulatory obligations and restrictions imposed on FCMs by the CFTC with respect to customer asset accounts, namely:

1. Investment Advisers are not required to maintain any minimum net capital amounts, whereas FCMs must maintain very large amounts of regulatory capital;
2. Investment Advisers are not required to obtain detailed “acknowledgement letters” from each custodian or depository that holds customer assets, as FCMs are required to;
3. Investment Advisers are not required to report the amounts held in these custodial accounts as FCMs are required to do;
4. Investment Advisers are not required to invest any of their own capital into their customer custody account whereas all FCMs do so; and
5. Investment Advisers are not subject to a large number of very specific rules relating to these custody accounts as FCMs are.

Judge Zagel’s First Conclusion of Law

Sentinel II is a case of first impression regarding the bankruptcy of a firm registered as both an FCM and as an IA. The issue before Judge Zagel in Sentinel II was whether the statutory trust created by Sections 4d(a) and 4d(b) of the CEA was superior to the IA Custody Rule adopted by the SEC. Defendant FCStone made several arguments in support of this theory, namely:

1. The customer protections provided by Congress in Sections 4d(a) and 4d(b) of the Commodity Exchange Act of 1936 were stronger than those resulting from a single SEC regulation requiring funds to be held with a cus-
todian. In fact, Congress has never enacted any such similar provision in the IAA.

2. Sections 4d(a) and 4d(b) of the CEA emphatically states that the assets held in a Customer Segregated Account must be treated as customer property “belonging to” the customer regardless of their location. In other words, the CEA created a “floating trust” over such customer property whereas the IA Custody Rule merely requires that customer assets only be segregated from the IA’s own assets. Therefore, Sections 4d(a) and 4d(b) made clear that the statutory trust imposed on customer segregated funds means that the assets in question, e.g., the SEG Pool assets, could never be treated as the property of the depository (e.g., Sentinel). Therefore, unless the SEG 1 Pool assets become property of the Sentinel estate, it could never be clawed back by the Trustee and redistributed to the SEG 3 Pool. Any such redistribution was statutorily prohibited.

3. The legislative history accompanying Sections 4d(a) and 4d(b) of the CEA clearly demonstrate that segregation violations and improper commingling of customer funds do not destroy the statutory trust created under the CEA. Congress did not intend to protect IA advisory client funds in the same manner as FCM customer funds because no provision under the IAA provides the specific customer protections that Sections 4d(a) and 4d(b) do.

4. The risks unique to the futures markets demand that FCM customer-held property be afforded heightened protections compared to IA customer funds.

5. The CFTC has promulgated a series of detailed regulations regarding how customer assets must be held, reported and maintained whereas the IA Custody Rule merely requires that customer assets be held in one of three types of custodian firms.

Judge Zagel did not accept any of these arguments and held that the IA Custody Rule is also a statutory trust, just like Sections 4d(a) and 4d(b), and that Congress did not intend to elevate protections for customer funds regulated by the CEA and CFTC regulations over customer funds regulated by the IA Custody Rule. He then stated: “there is no basis in law for elevating one federal statutory trust over another absent the tracing of specific property.” Judge Zagel basically holds that when two trusts require segregation, without analyzing any other requirement, then the two trusts must be treated equally. He then stated:

“Until Congress demonstrates a clear intention to give commodity customers so-called ‘super priority’ in bankruptcy, I have no basis for elevating the interests of the CEA over IAA-protected customers.”

Query, will the Seventh Circuit accept Judge Zagel’s analysis? I do not think so. While the IA Custody Rule does create a “regulatory” trust, the simple requirement of segregation under the IA Custody Rule should not elevate that regulation to an equivalent statutory trust created by the CEA. If Congress wanted to create a statutory trust under the IAA, a law enacted four years after Section 4d(a) was added to the CEA, it could have done so. Instead, all Congress did was to give the SEC the authority to adopt a general anti-fraud rule. True, Congress knows that SEC Rule 206(4)-2 requires an investment adviser to place customer funds with a third party custodian. However, one cannot elevate Congressional intent, as Judge Zagel seems to have done, to hold that a specific statutory trust regarding how futures customer funds are held to be treated the same as an SEC regulation regarding customer assets held by a custodian selected by an investment adviser. Statutory construction simply should not work that way. One must look to the legislative history in analyzing the respective laws. And nowhere will you find any legislative history regarding the use of a custodian by investment advisers. That is because no such law existed at the time of the Sentinel bankruptcy filing. If Congress wanted to treat both types of trusts as equal, as Judge Zagel has done, then the SEC should have sought such specific legislation regarding funds managed by an IA. Moreover, Judge Zagel ignored all of the...
specific regulations applicable to FCMs regarding how customer funds must be held in trust and that IAs, such as Sentinel, could have placed its customer assets with a broker-dealer or an FCM, and thus have received special asset protections.

In its Amicus Brief filed in Sentinel II in the Seventh Circuit, the CFTC argued that while the language of Section 4d (and related Section 4(d) (b)) does not actually use the word 'trust', "the rights and duties they create are precisely the sort that establish a trust both at common law and in other statutory concepts. The statutory scheme defines a res subject to the trust—the cash and property received by the FCM from its customers." The CFTC then added: "And the statute and the implementing regulations impose a variety of restrictions on how the res can be treated by the FCM." The CFTC then states that "Section 541(d) of the Bankruptcy Code provides that the property of the bankruptcy estate does not include property in which the debtor holds (e.g., Sentinel)." It only holds legal title but not equitable title. It goes on to state:

"While section 6d relies on segregation as an important protection for commodity customer funds, its reach extends to customer assets that an FCM or depository acting for an FCM has improperly failed to keep segregated".... But the provision (e.g., Section 6d) also separately requires that the FCM "treat and deal with all money, securities and property (received from a customer to serve as margin) ... as belonging to such customer." The CFTC in its Amicus Brief then stated, referring to the statement made by Judge Zagel that the assets held by Sentinel were subject to a statutory trust arising out of SEC regulations, and thus gave Sentinel's securities customers an equally enforceable claim to the same trust protections as the SEG 1 Pool:

"The CFTC believes that this holding, by treating commodity customer funds as property of the entity holding them (e.g., as assets of the bankrupt estate) rather than the property of customers, is fundamentally inconsistent with 7 U.S.C. § 6d and, if upheld, could have consequences for the security of commodity customer funds going beyond the facts of this particular case.

The district court's conclusion does not follow from its premises. The court's reasoning at most establishes a reason for some degree of parity treatment between commodity and securities customers. It does not justify treating customer funds as simply the property of the debtor, making them available for payment to creditors generally."

The SEC in its Amicus Brief in Sentinel II in the Seventh Circuit obviously argued differently. It stated as follows:

"In the SEC's views, contrary to FCStone's position, the custody rule provides advisory clients with segregated asset protection for client property that is as strong and as important as the segregated assets protection the CEA and related regulations provide to commodities customers."

The SEC, like the CFTC, applied the ongoing trust principle by stating:

"The import of (the custody rule) ... is that client funds never lose that character merely because an investment adviser ... takes possession of them." Citing Griffiths v. Peterson, 96 B.R. 314, 323 (Bankr. D. Colo 1988)"

The SEC went on to hold that there is no basis in law for elevating one federal statutory trust over another absent the tracing of specific property.

That argument thus raises the fundamental question before the Seventh Circuit. Do the specific customer segregation provisions set forth in the CEA and several CFTC regulations trump or not trump one SEC regulation. The relevant CEA section goes back to 1936 and was later amended in 1968 to extend the segregation obligation to custodians receiving segregated funds from FCMs. The applicable CFTC regulations have
also been around for decades. The applicable provision in the IAA merely gives the SEC the right to establish anti-fraud regulations for investment advisers. Using this statutory authority, the SEC adopted the IA Custody Rule. Query, are these two trusts equitable or competing? Should the commingling of the securities sold to Citadel have any impact on the rights of the futures customers regarding their assets held in the SEG 1 Pool?

I believe that the Seventh Circuit will overturn Judge Zagel's view that "equality is equity."

**Judge Zagel's Second Conclusion of Law**

Judge Zagel also held that FCStone is subject to common law tracing due to the co-equal claims of the competing trust claimants. He then stated that FCStone failed to meet this tracing standard. In fact, he stated that such tracing was impossible. FCStone's expert did in fact identify the location of the SEG 1 Pool assets but this, according to the court, is indicative of why tracing is not possible in this case. He then stated:

"But for tracing purposes, the critical shortcoming of Ms. McCloskey's report is that it fails to adequately account for the fact that none of Sentinel's customers (referring to the FCMs) held specific ownership interests in securities. Rather they own pro rata portions of investment portfolios which Sentinel was free to fill with any of the securities in its pool of assets so long as those securities met the portfolio's investment criteria."

Judge Zagel believed that the "fungible nature of cash alone makes it impossible to trace specific securities back to the original customer deposits in this case." He then stated:

"So, commingling aside, Sentinel's investment model makes tracing essentially impossible because, upon deposit, customer funds were immediately converted into an abstract ownership interest. In other words, Sentinel's pooled investment model renders tracing impracticable because there is no specific form of converted trust property to trace." in support of FCStone's position and that of the CFTC, the critical case to analyze is Begier v. I.R.S. Begier holds, in essence, that trust assets should not be deemed property of the bankrupt estate and that tracing is not required if a nexus can be shown between the assets received by the beneficiary and those held in trust by the debtor. In its Amicus Brief in Sentinel II in the Seventh Circuit case, the CFTC stated:

"The nexus approach requires that the federal trust claimant must establish 'some connection' between the original trust assets defined by the relevant statute and the 'assets sought to be applied' to the trust claim subsequently in circumstances where the original trust assets have been commingled or transferred (citing Begier, 496 U.S. at 65-66). The court has flexibility in determining what connection is sufficient in particular circumstances so long as it 'applies reasonable assumptions to govern the tracing of funds...' These reasonable assumptions can include, but are not restricted to, common law tracing." Judge Zagel held that, since the FCMs deposited cash with Sentinel, such cash is intangible and cannot be traced. The SEC in its Amicus Brief concurred with Judge Zagel and distinguished Begier by stating that Begier is inapplicable as Begier did not involve competing claims by beneficiaries of two trusts, as applies here. I also believe that the Seventh Circuit will disagree with Judge Zagel's analysis on this point as well. The CEA requires all FCMs to "treat and deal with all money, securities and property received ... to margin, guarantee, or secure the trades or contracts of any customer of such person, or accruing to such customer ..." The term "money" clearly refers to cash. Section 4d(b) further requires that depositories of commodity customer funds not "hold, dispose of, or use any such assets as belonging to the depositing futures commission merchant or any person
other than the customers of such futures commission merchant.”

While Sentinel was registered as an FCM, it is also acting as a depository for FCStone and the other FCMs that invested their customer assets through Sentinel. At all times, the customer assets must be held in segregation and be treated as belonging to futures customers. No such law or rule applies to investment advisers. The fact that Sentinel improperly commingled the SEG 1 Pool assets with the SEG 3 Pool assets does not remove this statutory trust feature from the FCM customer funds. Regardless of the location of the customer assets of FCStone, this statutory trust continues to apply. In essence, a floating trust applies, and continues to apply, to these customer assets at all times once the customer assets are deposited in a customer segregated account. That was the clear Congressional intent.

Moreover, Judge Zagel does not understand how customer segregation works in the futures industry. An FCM opens a Customer Segregated Account at a custodian bank. Its customers directly transfer their “cash, securities and property” into the FCM’s Customer Segregated Account at the custodian bank, a commingled omnibus-type account. The mere commingling of customer assets in these customer segregated accounts, which is clearly permitted by the CEA and applicable CFTC regulations, does not destroy the statutory trust.

The FCM may never hold such funds held in these customer segregated accounts as belonging to the FCM. The FCM, as a clearing member firm, also acts as an agent on behalf of its customers and will transfer such customer cash, securities or property to the clearing house if any initial or variation margin is required to be transferred. The assets held at the clearing house are also maintained in a different commingled customer segregated account. In other words, the customer’s property is always required to be maintained in segregation. IAs, on the other hand, can receive customer property and then transfer it into one of three custodial accounts—at a broker-dealer (e.g., the most typical way), to another FCM (if it involves futures) or to a custodian bank. Sentinel chose the latter. Had it chosen either of the first two approaches, the customer funds held in the SEG 3 Pool would have been protected.

Also, many futures customers give cash to their FCM to meet their initial margin obligations. The FCM must account for and report various financial information to the customer, including the customer’s total amount of cash, securities or property held by the FCM on its behalf. This accounting clearly satisfies the tracing element. FCStone’s experts proved that. They were able to trace every dollar received by Sentinel from each FCM for investment in the SEG 1 Pool. The fact that cash is intangible should not control this analysis. In fact, when cash is received by an FCM, CFTC Rule 1.25 clearly permits an FCM to invest customer assets provided that any such investments comply with the permissible restricted investments. Therefore, an FCM can take customer cash, which is fungible, invest such cash in U.S. government securities, which is what FCStone did through Sentinel. However, the government securities that are purchased by the FCM with the customer’s cash belongs to and are held at all times for the benefit of the customers. Such government securities must be held in a Customer Segregated Account at all times. Regardless of their location, these government securities are deemed to be “customer property”, that is, funds belonging to the FCM’s customers whether the underlying assets are held in cash or government securities purchased by the FCM with such cash. All customer “monies, securities and property” held in these customer segregated accounts are held by the FCM as “belonging to the customer.”

Therefore, the common law tracing requirement imposed by Judge Zagel simply should not apply here. All such assets at all times belong to and for the benefit of the customers of that FCM regardless of what form the assets now take or their location. The applicable CFTC regulations require that there is a proper amount of funds held in the Customer Segregated Account regardless of their form. Thus, if an FCM invests $100,000 of cash received from ABC, a futures customer, into a $100,000 Treasury bill, ABC’s name need not be placed on that T-Bill. The T-Bill purchased with such cash is held in the Cus-
Customer Segregation Account of the FCM just like the cash would be. An FCM invests not just ABC’s cash but the cash of all customers held in the omnibus Customer Segregated Account when making such permissible investments under CFTC Rule 1.25. The key is not whether ABC’s $100,000 in cash can be identified through any specific investment but that ABC’s assets are protected, whether they be in same or like kind. In fact, CFTC Rule 190.10 specifically states that U.S. Treasury bills are not deemed to be “specially identifiable property” but are to be treated as cash.\(^59\) The fact that Ms. McCloskey could follow the movement of the exact amount that should have been held in Sentinel’s Customer Segregated Account should satisfy any tracing requirement.\(^60\)

**Judge Zagel’s Third Conclusion of Law**

Judge Zagel held that the transfer of assets to the Customer Segregated Accounts of FCStone (and all of the other FCMs) was not authorized by the Bankruptcy Code or by the Bankruptcy Court. As noted above, the U.S. Bankruptcy Court for the Northern District of Illinois authorized this distribution on August 20, 2007.\(^61\) Judge Zagel stated that the Bankruptcy Court did issue an Order stating that the assets, less a $15.6 million holdback, could be distributed to the Customer Segregated Accounts of the various FCMs. Judge Zagel then stated that the Order said nothing about whether the proceeds were property of the estate. Approximately, one year later, on August 8, 2008, the Trustee for Sentinel filed a Motion to Clarify or in the Alternative to Vacate or Modify the Court’s August 20, 2007 Order. In open court, the judge then explained that the August 20, 2007 Order had not ruled on the “property of the estate” issue.

From a practical perspective, the funds distributed to FCStone’s customers in August 2007 belonged to its customers who were free to remove those funds from FCStone. This distribution was clear and should be enforced. To hold otherwise will greatly jeopardize the U.S. futures markets as how will any FCM know whether the FCM may later be held liable for funds distributed to a third party, namely its customers, five years earlier? FCStone, and all of the other FCMs, must be permitted to rely on a Court Order as they did back in August 2007. In fact, several of the FCMs then queried other regulators to inquire whether these funds could ever be clawed-back; the regulators said “no.” If they knew that they could be claw backed five years later, these funds might have been held in trust pending a further outcome.

To hold as Judge Zagel did implies that an FCM is liable for the acts of any depository that it selects to hold customer assets. Sentinel was a depository that was registered as an FCM. There has never been any CFTC pronouncement that an FCM is liable under these circumstances.\(^62\) In fact, it was just recently that the CFTC has raised this issue and has asked for comments whether an FCM should be held to be so liable.\(^63\) This regulation or even an advisory has never been publicly pronounced by the CFTC.

Finally, Judge Zagel focused on one word in the Authorization Order, that is, that the custodian bank “may” immediately distribute the Proceeds to Debtor’s clients. Judge Zagel then stated that the Authorization Order reserved some rights. However, these rights appear to involve the right of the Trustee to seek legal action with respect to the “holdback”\(^64\) (e.g., the amount held back pursuant to the Bankruptcy Court’s Order) and any actions regarding claims for priority under Section 761-767.\(^65\)

One year later, the Bankruptcy Court issued an Order clarifying that it never ruled that the Citadel proceeds distributed were or were not property of the bankrupt estate. Query, should this Order issued one year later, which Judge Zagel relied upon, override the authorization test. If any transfer of property, including property of the bankrupt estate, had been authorized, it cannot be claw backed.\(^66\)

Judge Zagel’s ruling could have serious impact on future FCM bankruptcies. It raises questions about the ability of an FCM to accept customer assets from a failed FCM not knowing whether such customer assets may be clawed back in the future. Moreover, FCMs are not currently required to be held liable by the acts of another
FCM or a depository regarding customer funds that it has given to such entities. 67

INITIAL TRANSFEREE ISSUE IN SENTINEL II

Another critical issue arising from Sentinel II is whether FCStone was an “initial transferee” or not. In other words, was the distribution made to FCStone’s Customer Segregated Account for the benefit of FCStone or not. Judge Zagel concluded that it was. 68 This finding was critical or the post-petition distributions made on August 20, 2007 to the Customer Segregated Accounts of the various FCMs could not be voided.

Interestingly, the U.S. Bankruptcy Code does not define the term “initial transferee.” The various circuits have applied different theories to define this term. The Seventh Circuit has applied a “dominion and control” test to determine the initial transferee test. 69 To meet this test, the party must have dominion over the money or other assets and the right to put the money to one’s own purpose. 70 I believe that the Seventh Circuit will also decide against Judge Zagel on this issue.

FCMs merely act as a conduit over their futures customer assets. As noted above, all futures customer assets are held in a customer segregated account, and all “monies, securities and property” held in these segregated accounts constitute “customer property” belonging to the customers of the FCM. The FCM merely acts as a trustee over such funds, transferring the underlying assets either to a clearing house or back to the customer, as the case may be. True, an FCM may invest such customer property, pursuant to CFTC Rule 1.25 as noted above, but all such investments, and any interest earned on such investments, constitute “customer property” while held in the customer segregated account. Under such circumstances, they do not belong to the FCM until such interest is distributed from the customer segregated account to the FCM.

Judge Zagel acknowledged that this is a case of first impression on this issue relating to an FCM. All prior cases involve the liquidation of a stock brokerage firm which clearly have the right to use customer assets on behalf of the broker-dealer. In deciding this issue, Judge Zagel focused on the fact that FCMs deposit their own capital, normally referred to as “residual interest”, into their Customer Segregated Accounts. FCMs make such capital investment in order to ensure that the assets in these specially-protected accounts equal or exceed the required amount, and thus avoid a shortfall. 71 Judge Zagel opined that since FCMs function “as a de facto guarantor for all of its customer funds invested with Sentinel”, then it must be an initial transferee. 72

This is where Judge Zagel’s logic fails, in my opinion, and the Seventh Circuit will reverse his decision. As noted above, there has never been a pronouncement that an FCM acts as a guarantor over assets that it may deposit with a depository and that depository, for whatever reason, misappropriates such customer assets. The role of the residual interest merely provides a buffer to ensure against a shortfall. Once deposited, the residual interest constitutes “customer property” in the customer segregated account. Until just recently, no FCM was even required to make a residual interest in its customer segregated account. 73 The mere fact that FCMs do deposit their own funds in their customer segregated accounts should not cause them to become an initial transferee. FCMs merely hold their customer funds in trust and act a mere conduit with respect to them. The post-petition distributions were, in my opinion, made solely for the benefit of the customers of the FCMs. 74

POSSIBLE IMPACT OF THE SEVENTH CIRCUIT’S DECISION IN SENTINEL I

In a prior case involving Sentinel, Frederick Grede as the Liquidation Trustee, filed a case against Bank of New York Mellon (“BONY”), which acted as the custodian for Sentinel’s repo and futures customer accounts. Grede sought $312 million from BONY claiming that BONY knew about Sentinel’s fraudulent use of its customer assets and thus BONY acted inequitably and unlawfully. On August 12, 2012, Judge Zagel ruled that BONY was not liable for the actions taken by Sentinel with respect to its fraudulent movement of assets from its customer
accounts to an account held in the name of Sentinel on BONY's books. Judge Zagel found that Grede had "failed to prove that Sentinel made the Transfers with the actual intent to hinder, delay or defraud its creditors." On November 30, 2012, without any explanation, the Seventh Circuit vacated Judge Zagel's decision in Sentinel I and held that this appeal remains under consideration by the panel. On August 26, 2013, the Seventh Circuit overturned Judge Zagel's lower court decision regarding Grede's fraudulent transfer and equitable subordination claims and remanded the case back to the district court for further proceedings.

In its decision in Sentinel I, the Seventh Circuit disagreed with Judge Zagel's analysis of several of the facts and thus his conclusion of the law. For example, the Seventh Circuit disagreed with Judge Zagel's conclusion that the transfer of such funds to purchase the repos in Sentinel's name at BONY "was not enough to show that Sentinel had the actual intent to hinder, delay or defraud its FCM clients." The Seventh Circuit then stated that Sentinel's pledge of the segregated funds "was driven by a desire to stay in business correctly identified the motive." The Seventh Circuit then concluded that such motivation did constitute the "actual intent" and thus constituted a fraudulent transfer. The Seventh Circuit further believed that Sentinel did in fact expose "its FCM clients to a substantial risk of loss of which they were unaware when it pledged funds that were supposed to remain segregated for the FCM clients."

The Seventh Circuit then states:

"Sentinel's pledge of the segregated funds as collateral for its own loans becomes particularly egregious when viewed in light of the legal requirements imposed on Sentinel by the Commodity Exchange Act (CEA). Again, even if we assume that Sentinel eventually intended to replace the segregated funds and earn greater returns for their FCM clients, Sentinel knew that its pledge of the segregated funds violated the CEA. The CEA exists explicitly for the purpose of "ensur(ing) the financial integrity of all transactions" involving FCMs, "avoid(ing) systemic risk", and "protect(ing) all market participants from ... misuses of customer assets." 7 U.S.C. § 5(b). In order to further these aims, the CEA requires that the "money, securities, and property (belonging to clients) shall be separately accounted for and shall not be commingled with the funds of such commission merchant." 7 U.S.C. § 6(d)(a) (2). Moreover, 7 U.S.C. § 6(d)(b) makes it "unlawful; for an FCM "to hold, dispose of, or use any such money, securities, or property as belonging to the depositing futures commission merchant.""

One possible consequence if the lower court, on remand, rules that BONY must equitably subordinate its secured claim to unsecured claim status and the Seventh Circuit in Sentinel II affirms the claw back, then it is quite possible that a large amount of the Sentinel estate could be redistributed back to BONY. Query, is this something that the regulators and the courts have contemplated?

The Seventh Circuit has previously ruled that the CFTC has "exclusive jurisdiction" over the futures markets in cases brought by the SEC and in favor of FCM's actions regarding the consequences of a customer's default in not making the required margin payments. In light of the recent FCM bankruptcies involving MF Global and Peregrine Financial Group, and given the language noted above in the Seventh Circuit's opinion in Sentinel I, I believe that the Seventh Circuit will reverse Judge Zagel's decision in Sentinel II. Nowhere in its opinion does the Seventh Circuit mention the SEG 3 Pool in Sentinel I. Its decision focused solely on the protections afforded futures customers under the CEA.

IMPACT OF MADOFF CASE BEFORE THE SECOND CIRCUIT

In In Re: Bernard L. Madoff Investment Securities, LLC, the Second Circuit must decide whether the SIPA Trustee appointed to handle the Madoff broker-dealer bankruptcy may or may not claw back any assets distributed to Madoff customers regarding assets acquired in the Ponzi scheme. Although this claw back issue is not di-
CONCLUSION

FCStone has appealed Judge Zagel's ruling. It will be interesting to see how the Seventh Circuit might rule in Sentinel II. The oral arguments were held in the Seventh Circuit on December 10, 2013. The Seventh Circuit, more than any other circuit, has a great understanding of the futures markets and has often issued decisions based on the economic impact of a lower court's decision. In my opinion, I believe that the Seventh Circuit will reverse Judge Zagel's lower court decision in Sentinel II and order a retrial. To rule otherwise means that the Seventh Circuit would allow the claw back to occur, some six years after the customer funds were distributed to the FCStone’s Customer Segregated Account, which will have a devastating effect on FCMs and the futures industry.

The CFTC and the exchanges, in the event of an FCM’s bankruptcy, reach out to other FCMs to accept the non-defaulting customers of the failed FCM. If a claw back is later permitted, why should FCMs work with the CFTC and the exchanges in such circumstances. The CEA provisions and specific CFTC regulations dealing with protecting customer assets should, in this author’s opinion, trump the SEC regulation on the IA Custody Rule. It’s unfortunate that the customer assets held in the SEG 3 Pool might not be treated equitably, but Sections 4d of the CEA and CFTC Regulations 1.20 through 1.29, which are quite detailed in nature, should be the rule of law in this case.

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END NOTES

1. Ronald Filler is a Professor of Law and the Director of the Financial Services Institute at New York Law School. He is also the Program Director of its award-winning LLM in Financial Services Law Graduate Program, which offers more than 40 courses involving various aspects of the global financial services industry. He is a Public Director of the National Futures Association, the futures industry self-regulatory organization, of NYSE Liffe US, a U.S. futures exchange, and of SWAP-EX, a swap execution facility. He is Chair of the CFTC Global Markets Advisory Committee and has served on numerous industry boards and advisory
committees throughout his professional career.

Prof. Filler served as an expert witness on behalf of FC Stone in the federal district court case in Sentinel II.

2. Pursuant to Section 4d(a) of the Commodity Exchange Act, 7 U.S.C. 6d(a), and CFTC Regulation 1.20, 17 C.F.R. 1.20, all futures commission merchants ("FCMs") must hold all futures customer assets in a "customer segregated account."

3. Frederick J. Grede, not individually but as Liquidation Trustee of the Sentinel Liquidation Trust, v. FCStone, LLC, No. 09 C 136 (N.D. III). (hereinafter referred to as Sentinel II).

4. See Order issued by the U.S. Bankruptcy Court for the Northern District of Illinois, in In Re: Sentinel Management Group, Inc., Case No. 07-14987 (August 20, 2007)

5. Sentinel Management Group, Inc. filed for bankruptcy on August 17, 2007, supra, Note 3.

6. 14 FCMs were sued by the Trustee to claw-back the amounts distributed in August 2007, into the Customer Segregated Accounts but these actions were not consolidated. This case is a test case and only involves FC Stone, and none of the other FCMs. The other cases against FCMs, which invested in the SEG 1 Pools, have been deferred.

7. Since Sentinel did not act as a traditional FCM, the bankruptcy provisions under the U.S. Bankruptcy Code did not apply to Sentinel (See page 16 of the Memorandum Opinion and Order). Therefore, Part 190 of the CFTC Rules, 17 C.F.R. Part 190, also did not apply to this case.

8. See Letter from John L. Manley, Director, CFTC Division of Trading and Markets, to Terry I. Claassen, O'Neal & Claassen, dated May 7, 1981. See also CFTC Interpretation Letter 04-06 from James Carley, Director, CFTC Division of Clearing and Intermediary Oversight, to Eric Bloom, President & CEO, Sentinel Management Group, Inc., dated January 21, 2004.

9. See CFTC Rule 1.25, 17 C.F.R. 1.25, which permits FCMs to invest futures customer assets in certain permissible investments.

10. The SEG 2 Pool involved other assets not at issue in this case.

11. 15 U.S.C. 80b-1 et seq. (hereinafter referred to as the "IAA").

12. Supra, Note 3 at pages 15-17.


14. Ibid.

15. Judge Zagel used this number. Supra, Note 3. However, if you multiplied 32% times $14,479,000, you come up with a smaller number.

16. Supra, Note 3 at page 2.

17. Supra, Note 3 at page 1.


19. See CFTC Rule 1.3(2), 17 C.F.R. 1.3(2), for a definition of a "bona-fide hedger."

20. A large portion of SIPC funds are also funded directly by broker-dealers.

21. Stock accounts are protected by the Securities investors Protection Act ("SIPA"), which specifically prohibits futures customer accounts from being subject to this act.


24. In 1985, another FCM, Volume Investors, failed, resulting in a small shortfall but this shortfall was paid in full by the firm's principals. See also In Re Griffin Trading Company, U.S. Bankruptcy Court for the Northern District of Illinois, Eastern Division, Case No. 98 B 41742 (January 29, 2009), in which there was a shortfall in its Secured Amount Account permitted by CFTC Part 30, 17 C.F.R. Part 30.


27. CFTC Rule 1.17, 17 C.F.R. 1.17.


29. This has always been a monthly reporting requirement. Just recently, FCMs must report the amounts held in a Customer Segregated Account on a daily basis. See NFA Financial Requirement Section 16.

30. On October 30, 2013, the CFTC adopted amendments to its customer asset protections rules which require, among other things, that FCMs deposit larger amounts of residual interest in their customer segregated accounts, secured amount accounts and cleared swap accounts. See CFTC Press Release, PR 6746-13, October 23, 2013 and 78 F.R. No. 220 at page 68506 (November 14, 2013).

31. See CFTC Rules 1.20 through 1.29, 17 C.F.R. 1.20 through 1.29

32. See In Re Bucyrus Grain Co., Inc, 127 B.R. 45 (D. Kan 1988)

33. Section 4(d)(a) of the CEA was enacted in 1936 to establish this statutory trust in order to protect futures customers who deposit their margin with their FCMs. Some quotes from Senator Bronson Murray, the sponsor of the CEA amendments, in the legislative reports include: (i) "Surely they thought their margins were regarded as trust funds and would be handled with a reasonable degree of integrity."; (ii) "This section merely provides that the public's money put up for margins shall in fact be treated as belonging to the customer and held in trust."; and (iii) "This mandatory trust fund status was intended to stop the then-common practice in the industry whereby
futures commission merchants receiving margin monies in excess of the amounts required by the exchange to be deposited, (then) use these excess margin deposits as their own capital, for any purpose they choose." 80 Cong. Rec. 7858 (May 25, 1936).

34. See CFTC Rules 1.20 through 1.29, 17 C.F.R. 1.20—1.29
35. Supra, Note 3 at page 24.
36. Ibid at page 27.
37. Congress added Section 223 to the IAA when it enacted the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank"), Pub L. 111-203, 124 Stat. 1376 July 16, 2013. This section requires a registered investment adviser to "take such steps to safeguard client assets over which the adviser has custody as the Commission may, by rule, prescribe", in reference to the recent Ponzi scheme of Madoff Investment Services, LLC.

38. Supra, Note 3
39. If the Seventh Circuit affirms Judge Zagel's decision, this means that any such claw backs of the funds distributed to the Customer Segregated Accounts of the various FCMS would not just flow back to the SEG 3 Pool and distributed pro rata but will also be distributed to general unsecured creditors of Sentinel's estate, as the Sentinel Liquidation Trust treats all unsecured creditors equally. See also the section below in Sentinel I on the Seventh Circuit case.
41. Ibid.
42. Ibid, at page 9.
43. Ibid.
44. Ibid.
45. Ibid, at page 12.
47. Ibid, at page 4.
49. See Chrysler Corp. v. Brown, 441 U.S. 281 (1979), which held that "a properly promulgated, substantive agency regulation" has the same "force and effect" as if it had been passed directly by Congress (at page 295). Query, was Chrysler intended to uphold Judge Zagel's conclusion to a firm, such as Sentinel, that was registered with both the CFTC and the SEC?
50. Supra, Note 3 at page 37.
51. Ibid.
53. See CFTC Amicus Brief, at page 13.
54. Supra, Note 3 at page 37.
55. See SEC Amicus Brief, at page 14.
56. See Section 4d(a) of the CEA, 7 U.S.C. 6d(a).
57. See Section 4d(b) of the CEA, 7 U.S.C. 6d(b) (emphasis added).
58. See Section 4d of the CEA, 7 U.S.C. 6d.
59. CFTC Rule 190.10, 17 C.F.R. 190.10.
60. In its Amicus Curiae Brief filed in Sentinel II before Judge Zagel, the SEC stated that its premise was based on the presumption by Fred Grede, the Trustee, that "it was impossible to meaningfully trace client property". See SEC Amicus Curiae Memorandum filed in the district court before Judge Zagel.
61. Supra, Note 4.
62. See Brief of Amicus Curiae, Futures Industry Association, in Support of Appellant FCStone, LLC and Urging Reversal, at pages 18-20 (June 6, 2013). In its Amicus Brief, the FIA stated: "Accordingly, the FCM community has operated for over forty years on the understanding that FCMs are not liable for customer losses caused by the insolvency of third-party custodians", citing the Administrative Determination No. 230 issued by the Commodity Exchange Authority, a division of the U.S. Department of Agriculture. At page 18.
63. Supra, Note 30.
64. The Authorization Order required that $15 million be held back and not distributed to the Customer Segregated Accounts.
65. See page 26 of the Brief of Defendant-Appellant FCStone, LLC. FCStone goes on to argue that claw backs were never contemplated by the Authorization Order.
66. See Section 549(a)(2) of the U.S. Bankruptcy Code.
67. Supra, Note 49.
68. Ibid at page 42.
70. Ibid.
71. Once a shortfall occurs, the FCM must immediately cease to do business.
72. Supra, Note 3 at page 43.
73. Supra, Note 30.
74. In its Brief, FCStone argues that it was neither a Transferee or an Initial Transferee as it did not recent any actual or quantifiable benefit from the post-petition distribution. See Note 64, supra.


78. Ibid at page 12.

79. Ibid at page 13.

80. Ibid.


82. Ibid, see page 15.

83. See Board of Trade of the City of Chicago v. S.E.C., 677 F.2d 1137 (Seventh Cir, 1982).

84. See ADM Investor Services Inc. v. Collins, 515 F.3d 753 (Seventh Cir 2008).

85. In Re: Madoff Investment Services, LLC, Second Circuit, Case Nos. 12-2497-bk (CON et al).


88. Ibid at page 10.

89. Supra, Note 3 at page 45, citing Count II, Avoidance of a Preferential Transfer.

90. Ibid, at page 46.